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IN THE
Supreme Court of the United States

OCTOBER TERM, 1994

20TH CENTURY INSURANCE CO., *et al.*,
Petitioners,

v.

JOHN GARAMENDI, INSURANCE COMMISSIONER, *et al.*,
Respondents.

Petition for a Writ of Certiorari to the Supreme Court of California

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

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APPENDIX A

SUPREME COURT OF CALIFORNIA
IN BANK

No. S032502

20TH CENTURY INSURANCE COMPANY *et al.*,
Plaintiffs and Respondents,

v.

JOHN GARAMENDI, as Commissioner, etc.,
Defendant and Appellant.

20TH CENTURY INSURANCE COMPANY, *et al.*,
Plaintiffs and Respondents,

v.

JOHN GARAMENDI, as Commissioner, etc.,
Defendant and Appellant;

VOTER REVOLT,
Intervener and Appellant.

HARTFORD STEAM BOILER INSPECTION
AND INSURANCE COMPANY *et al.*,
Plaintiffs and Respondents,

v.

JOHN GARAMENDI, as Commissioner, etc.,
Defendant and Appellant.

Aug. 18, 1994

MOSK, Justice.

At the November 8, 1988, General Election, the voters approved an initiative statute that was designated on the ballot as Proposition 103. The measure made numerous fundamental changes in the regulation of automobile and other forms of insurance in California. Formerly, the so-called "open competition" system of regulation had obtained, under which "rates [were] set by insurers without prior or subsequent approval by the Insurance Commissioner. . . ." (*King v. Meese* (1987) 43 Cal.3d 1217, 1221, 240 Cal.Rptr. 829, 743 P.2d 889.) Under that system, "California ha[d] less regulation of insurance than any other state, and in California automobile liability insurance [was] less regulated than most other forms of insurance." (*Id.* at p. 1240, 240 Cal.Rptr. 829, 743 P.2d 889 (conc. opn. of Broussard, J.).) The initiative contained, among others, provisions relating to the rollback of rates for insurance within its coverage for the period extending from November 8, 1988, through November 7, 1989. (For purposes here, a rate is the price or premium that an insurer charges its insureds for insurance.)

It scarcely needs mention that the regulation of the insurance industry is squarely within the state's police power. "What [has been] said about the police power—that it 'extends to all the great public needs' and may be utilized in aid of what the legislative judgment deems necessary to the public welfare, [citation]—is peculiarly apt when the business of insurance is involved—a business to which the government has long had a 'special relation.' " (*California Auto. Assn. v. Maloney* (1951) 341 U.S. 105, 109, 71 S.Ct. 601, 603, 95 L.Ed. 788.)

In *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805, 258 Cal.Rptr. 161, 771 P.2d 1247 (hereafter sometimes *Calfarm*), we upheld, inter alia, Proposition 103's provision requiring rate rollbacks.

In this proceeding, we review the implementation of Proposition 103's rate rollback requirement provision by

the Insurance Commissioner. The incumbent is John Garamendi, the first person elected to the office. His predecessor was Roxani M. Gillespie, who was appointed thereto.

Specifically, we decide appeals and cross-appeals from a judgment of the Los Angeles County Superior Court in three consolidated cases in Judicial Council Coordination Proceeding No. 2419, entitled "Proposition 103 Implementation Cases." We transferred the cause, which was then pending in No. B074704 in the Court of Appeal, Second Appellate District, to ourselves because it "presents issues of imperative public importance requiring prompt resolution" by this court "and justifying a departure from normal appellate processes." (Cal.Rules of Court, rule 27.5(b).) The cases are as follows.

1. 20th Century Insurance Company et al. v. Garamendi (Super.Ct. S.F. County, 1991, No. 938470, trans., Super.Ct. L.A. County, 1992, No. BC046216) (hereafter *20th Century I*). This action concerns, inter alia, the validity of rate regulations adopted by the Insurance Commissioner as to rollbacks both on their face and as applied. The regulations in question include regulations strictly so called: rules generally applicable to all insurers formulated by the commissioner in quasi-legislative proceedings in File No. RH-291. They include as well regulations incorporating "generic determinations": findings relating to all or at least several insurers made by the commissioner in consolidated hearings conducted in accordance with quasi-adjudicatory procedures and then adopted by him as regulations—specifically, findings arising from (1) File No. RCD-1, concerning exposure basis, reserve strengthening, executive compensation, efficiency standards, etc.; and (2) File No. RCD-2, concerning rate of return, leverage factor, projected yield, etc. This action also concerns the constitutionality of Proposition 103's rate rollback requirement provision both on its face and as applied. The parties include 20th Cen-

tury Insurance Company and 21st Century Casualty Company (hereafter collectively 20th Century) as plaintiffs (and, formerly, petitioners) and the commissioner in his official capacity as defendant (and, formerly, respondent).

2. 20th Century Insurance Company et al. v. Garamendi (Super.Ct. L.A. County, 1992, No. BS016789) (hereafter *20th Century II*). This action involves, among other issues, the validity of the rate regulations both on their face and as applied and also the validity of a rollback order issued by the Insurance Commissioner against 20th Century pursuant thereto. The parties include 20th Century as petitioners and the commissioner in his official capacity as respondent. By leave of court, Allstate Insurance Company (hereafter Allstate) and Voter Revolt, the proponent of Proposition 103, are interveners, the former on 20th Century's side, the latter on the commissioner's.

3. Hartford Steam Boiler Inspection and Insurance Company et al. v. Garamendi (Super.Ct. L.A. County, 1991, No. BC023983). This action concerns, inter alia, the validity of the rate regulations incorporating generic determinations, both on their face and as applied, relating to the issue of "leverage," i.e., the "surplus" or available capital that backs up premiums. It appears that the insurance industry's surplus is greatly represented by appreciating assets (such as stocks and bonds), as opposed to depreciating assets (such as plant and equipment). Over-leverage (or undercapitalization) threatens insolvency: there is insufficient surplus to back up premiums. By contrast, under-leverage (or overcapitalization) threatens undue profit: there is surplus beyond what is useful to back up premiums—surplus surplus—which inflates the insurer's capital base and any rate set thereon to the disadvantage of its insureds, while at the same time it produces investment income from appreciating assets. This action was bifurcated as to the leverage issue and consolidated with *20th Century I* and *20 Century II* with regard thereto. The parties include Hartford Steam Boiler Inspection and Insurance Company (hereafter Hartford)

and the State Farm Insurance Companies (hereafter State Farm), together with scores of other insurers, as plaintiffs and petitioners and the commissioner in his official capacity as defendant and respondent.

I. PROPOSITION 103 AND *CALFARM*

Among other things, Proposition 103 added the following sections to the Insurance Code.

Insurance Code section 12900.

This provision makes the Insurance Commissioner an elected official.

Insurance Code section 1861.01.

Subdivision (a) is the rate rollback requirement provision. "For any coverage for a policy for automobile and any other [specified] form of insurance . . . issued or renewed on or after November 8, 1988, every insurer shall reduce its charges to levels which are at least 20% less than the charges for the same coverage which were in effect on November 8, 1987."

Subdivision (b) defines the procedural mechanism for relief from the rate rollback requirement provision. "Between November 8, 1988, and November 8, 1989, rates and premiums reduced pursuant to subdivision (a) may be only increased [*sic:* read, "may be increased only"] if the commissioner finds, after a hearing, that an insurer is substantially threatened with insolvency."

Subdivision (c) institutes the "prior approval" system. "Commencing November 8, 1989, insurance rates . . . must be approved by the commissioner prior to their use."

Insurance Code section 1861.05.

Subdivision (a) articulates the substantive standard of the "prior approval" system. "No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of [speci-

fied law]. In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company's investment income."

Subdivision (b) defines the procedural mechanism for the "prior approval" system. "Every insurer which desires to change any rate shall file a complete rate application with the commissioner. . . . The applicant shall have the burden of proving that the requested rate change is justified and meets the requirements of" specified law.

The scheme for the regulation of rates thus established by Proposition 103 is as follows.

For the period extending from November 8, 1988, through November 7, 1989 (hereafter sometimes the rollback year or simply 1989), as a temporary regulatory regime of rate reduction and freeze evidently designed to allow the setting up of a permanent regulatory regime to follow, Proposition 103 itself sets a maximum rate for covered insurance at 80 percent of the rate for the same insurance in effect on November 8, 1987 (hereafter sometimes the 1987 rate).

For the period extending from November 8, 1989, into the future, Proposition 103 institutes a permanent regulatory regime comprising the "prior approval" system, under which, in the words of Insurance Code section 1861.05, subdivision (a), the Insurance Commissioner must approve a rate applied for by an insurer before its use, looking to whether the rate in question is "excessive, inadequate, unfairly discriminatory or otherwise in violation of" specified law—considering the "investment income" of the individual insurer and *not considering* the "degree of competition" in the insurance industry generally.[1]

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[1] Other systems include "file and use," which "[i]n theory at least . . . open[s] up somewhat greater competition" in rates among insurers, and "open competition," which "in theory en-

In *Calfarm*, we reviewed Proposition 103 against challenges under the United States and California Constitutions, including a claim that the rate rollback requirement provision was on its face invalid as confiscatory and arbitrary, discriminatory, or demonstrably irrelevant to legitimate policy in violation of the takings clause of the Fifth Amendment and article I, section 19 and the due process clause of the Fourteenth Amendment and article I, sections 7 and 15.[2] In the course of our analysis, we rejected the point. Our reasoning was as follows.

Proposition 103's rate rollback requirement provision, viz., Insurance Code section 1861.01, subdivision (a), which sets the maximum rate for the rollback year at 80 percent of the 1987 rate, would be facially invalid because confiscatory if rate adjustments necessary to avoid confiscation were not available for individual insurers. (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 820, 258 Cal.Rptr. 161, 771 P.2d 1247) ["The risk that the rate set by the statute is confiscatory as to some insurers from its inception is high enough to require an adequate method for obtaining individualized relief."].

Proposition 103's procedural mechanism for relief from the rate rollback requirement provision, viz., Insurance Code section 1861.01, subdivision (b), which allows an increase over the maximum rate for the rollback year of 80 percent of the 1987 rate only if the insurer is "substantially threatened with insolvency," is facially invalid because it precludes rate adjustments necessary to avoid confiscation, and further cannot be sustained as a tem-

---

courage[s] far greater competition in rates by permitting a company to establish new rates freely and to place them in effect promptly." (Keeton & Widiss, Insurance Law (1988) § 8.4(a)(3)(iii), p. 963.) As noted, the latter system, in its fullest form, obtained in this state before Proposition 103.

[2] In *Calfarm*, we used such phrases as the "due process clause" and "due process" to refer, of course, to the due process clause and its protection but also, more broadly, to the takings clause and *its* protection.

porary or emergency measure. (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at pp. 816-821, 258 Cal.Rptr. 161, 771 P.2d 1247.)

Insurance Code section 1861.01, subdivision (b), however, is severable from the balance of Proposition 103. (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at pp. 821-822, 258 Cal.Rptr. 161, 771 P.2d 1247.)

Insurance Code section 1861.05 is the "general standard for rate adjustment" for most rates and Insurance Code section 1861.01, subdivision (b), is an "exception" for rates for the rollback year. (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 822, 258 Cal.Rptr. 161, 771 P.2d 1247.)

The invalidation of Insurance Code section 1861.01, subdivision (b), "leaves untouched" Insurance Code section 1861.05. (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 822, 258 Cal.Rptr. 161, 771 P.2d 1247.) In other words, the "deletion" of the "exception" allows the "general standard" to be applicable in all cases. (*Id.* at pp. 822, 825, fn. 17, 258 Cal.Rptr. 161, 771 P.2d 1247.) The "general standard" declares, in subdivision (a) of Insurance Code section 1861.05, that "[n]o rate shall . . . remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of" specified law. Hence, the "general standard" "requires rates within that range which can be described as fair and reasonable. . . ." (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at pp. 822-823, 258 Cal.Rptr. 161, 771 P.2d 1247.) "The terms 'fair and reasonable' and 'confiscatory' are antonyms. . . ." (*Id.* at p. 816, fn. 5, 258 Cal.Rptr. 161, 771 P.2d 1247.) The range of fair and reasonable rates is defined in light of the insurer's legitimate interest in financial integrity and the insured's legitimate interest in freedom from exploitation. (See *id.* at p. 816, 258 Cal.Rptr. 161, 771 P.2d 1247 [implying that controls on rates must be " 'reasonably calculated to eliminate excessive' " charges to consumers " 'and at the

same time provide' " producers " 'with a just and reasonable return on their property' "].) A "confiscatory rate is necessarily an 'inadequate' rate. . . ." (*Id.* at p. 822, 258 Cal.Rptr. 161, 771 P.2d 1247.) Therefore, the "general standard" "prohibits . . . maintenance of confiscatory rates." (*Id.* at p. 823, 258 Cal.Rptr. 161, 771 P.2d 1247.)

It follows that subdivision (a) of Insurance Code section 1861.05 "provides a constitutionally valid standard for rate adjustment. . . ." (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 823, 258 Cal.Rptr. 161, 771 P.2d 1247.)

Accordingly, Insurance Code section 1861.01, subdivision (a)—which sets the maximum rate for the rollback year at 80 percent of the 1987 rate—is not facially invalid because confiscatory inasmuch as rate adjustments necessary to avoid confiscation are in fact available for individual insurers. (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at pp. 816-826, 258 Cal.Rptr. 161, 771 P.2d 1247.)

Further, under Proposition 103 "insurers will [not] be compelled to charge confiscatory rates pending administrative relief." (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 823, 258 Cal.Rptr. 161, 771 P.2d 1247.) There are "no . . . barriers to efficient decision making" in the initiative. (*Id.* at p. 824, 258 Cal.Rptr. 161, 771 P.2d 1247.) "Much is necessarily left to the Insurance Commissioner, who has broad discretion to adopt rules and regulations as necessary to promote the public welfare." (*Ibid.*) The absence of "barriers" is evident. For example, "[n]o provision bars the commissioner from consolidating cases or issuing regulations of general applicability. Thus there is nothing here which prevents the commissioner from taking whatever steps are necessary to reduce the job to manageable size." (*Ibid.*) "Moreover, the commissioner has the power to grant interim relief from plainly invalid rates. [His or her] powers are not

limited to those expressly conferred by statute; 'rather, "[i]t is well settled in this state that [administrative] officials may exercise such additional powers as are necessary for the due and efficient administration of powers expressly granted by statute, or as *may fairly be implied* from the statute granting the powers." ' [Citations] The power to grant interim relief is necessary for the due and efficient administration of Proposition 103, and may fairly be implied from its command that '[n]o rate shall . . . *remain in effect* which is excessive, inadequate, unfairly discriminatory or otherwise in violation of [specified law]." (*Id.* at pp. 824-825, 258 Cal.Rptr. 161, 771 P.2d 1247, italics in original.)

In conclusion, under Proposition 103 "any insurer who believes the rates set by [Insurance Code] section 1861.01, subdivision (a), are confiscatory may file an application with the Insurance Commissioner for approval of a higher rate. If that application is filed before November 8, 1989, the insurer may immediately begin charging that higher rate pending approval from the commissioner. After that date insurance rates subject to Proposition 103 must be approved by the commissioner prior to their use, but . . . the commissioner can approve an interim rate pending [his or] her final decision. If the commissioner finds the initiative's rate, or some other rate less than the insurer charged, is fair and reasonable, the insurer must refund excess premiums collected with interest. No insurer, however, will be compelled to charge the rates set by the initiative unless it either acquiesces in that rate or is unable to prove that a higher rate is constitutionally required." (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 825, 258 Cal.Rptr. 161, 771 P.2d 1247, fn. omitted.) "Proposition 103 contemplates that any rate set by the commissioner will be subject to judicial review." (*Id.* at p. 825, fn. 18, 258 Cal.Rptr. 161, 771 P.2d 1247.) The initiative added section 1861.09 to the Insurance Code, which expressly provides for such review. Under Insurance Code section 1861.01, subdivision (a)

—to use the terms appearing in Insurance Code section 1861.05, subdivision (a)—a rate is "inadequate" if confiscatory and "excessive" if more than minimally nonconfiscatory and above 80 percent of the 1987 rate.

II. THE PRESENT LITIGATION

Proposition 103 did not find rest after largely surviving the challenge mounted in *Calfarm*. Quite the contrary.

In *Fireman's Fund Ins. Co. v. Garamendi* (N.D.Cal. 1992) 790 F.Supp. 938 (hereafter sometimes *Fireman's Fund*), the federal district court provided a greatly abbreviated summary: "Insurers . . . filed over fifty lawsuits in California state courts, challenging many aspects of the Commissioner's effort to implement Prop[osition] 103." (*Id.* at p. 942.) "In December 1989, [the Chief Justice of California], in his capacity as Chairperson of the Judicial Council of California, assigned Sacramento Superior Court Judge Richard Park to determine whether the then four pending cases relating to the implementation of Proposition 103 should be coordinated pursuant to California Code of Civil Procedure section 404 *et seq.* and California Rules of Court, Rule 1501 *et seq.*, under the special title 'Proposition 103 Implementation Cases.' In January 1990, Judge Park issued an order coordinating the actions, and recommended to the Judicial Council that the cases be transferred to Los Angeles Superior Court for efficiency and the convenience of the parties. The Judicial Council adopted Judge Park's recommendation, and the coordinated cases were reassigned to Judge Miriam Vogel. After Judge Vogel was elevated to the Court of Appeal in May, 1990, [the Chief Justice] issued an amended order reassigning the Proposition 103 Implementation Cases, then 22 in number, to Judge Dzintra Janavs. Cases filed subsequently have either been formally added-on to the coordinated actions pursuant to Rule 1544 of the California Rules of Court, or have otherwise made their way before Judge Janavs. Presently, every Superior Court case relating to the implementation of Proposition

103 is or has been heard before her"—including those here. (*Id.* at p. 953, fn. 13.)[3]

To quote the words of the superior court spoken through Judge Janavs: "Proposition 103 [has] proved to be a problem child from its inception. It is doubtful whether any other initiative or legislative enactment has, in the span of just [a few] years, engendered more extensive administrative proceedings and as much litigation as Proposition 103."

The historical background is sketched in the *Fireman's Fund* court's opinion. (*Fireman's Fund Ins. Co. v. Garamandi, supra,* 790 F.Supp. at pp. 941-944). Two aspects deserve mention.

The first concerns the validity of the rate regulations, as it were, in context.

The Insurance Commissioner's predecessor had issued what is commonly referred to as her "Amended Decision."

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[3] Insurers have mounted their attack not only in state court but also in federal. (See *Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at p. 964 ["Insurers doing business in California certainly have a right to challenge any unconstitutional aspects of the rate making process which have been forced on them by the initiative. But the multiple and overlapping assertions of these challenges in state court, before the Commissioner, and in this court causes this court to question those tactics. Numerous insurers are involved in these multiple challenges, some represented by the same law firms. Some challenges are filed in state court and some are filed in federal. The challenges are at the same time identical, separate and overlapping. Some of that appears to be coordinated and calculated (for example, the filing of the two complaints in these actions minutes apart). And most of the significant issues in these two cases are already pending in state court. The net result is to bring this court into an already complex and protracted process of litigation. Is that forum-shopping, or deliberate complexity, or merely the difficulty of the issues?"].) In federal court, it may be noted, the attack has been turned away, at least for the present. (See *id.* at p. 966 [entering a judgment of dismissal in favor of the Insurance Commissioner and against certain insurers and related parties in two actions brought by the latter against the former on the ground that the underlying claims were not ripe].)

She subsequently adopted its substance as rate regulations —which included regulations strictly so called and also generic determinations. Shortly after taking office, the present commissioner announced his intention to depart from the path charted in the Amended Decision and to strike out on a different one. Specifically, he gave notice that he proposed to repeal his predecessor's rate regulations and to adopt his own in their place. He did so. His action was validated in *Safeco Ins. Co. v. Garamendi* (1992) 21 Cal.App.4th 1428, 14 Cal.Rptr.2d 621, review granted March 25, 1993 (S030921), and *State Farm Mut. Auto. Ins. Co. v. Garamendi* (1992) 22 Cal.App.4th 1095, 15 Cal.Rptr.2d 546, review granted March 25, 1993 (S030917). In *Safeco* and *State Farm,* the Court of Appeal, Second Appellate District, Division Five, concluded in substance that the commissioner had proceeded lawfully: his predecessor's Amended Decision did not bind him because it was quasi-legislative and not quasi-adjudicative; her rate regulations could yield to his. These issues, however, are not raised in this proceeding.

The second aspect concerns the validity of the rate regulations, so to speak, in and of themselves.

The Office of Administrative Law (hereafter the OAL) has the authority to review and either approve or disapprove certain regulations. (See generally, Gov.Code, § 11349 et seq.) Several times, the Insurance Commissioner submitted the rate regulations (in various forms) to the OAL. Several times, the OAL disapproved them, concluding, inter alia, that they are beyond the authority conferred on the commissioner by Proposition 103 (see Gov.Code, § 11349.1, subd. (a)(2)) and also inconsistent with the initiative's terms (see *id.*, § 11349.1, subd. (a)(4)) because they impermissibly "restrict an insurer's right to obtain relief from confiscatory rates."

Regulations are generaly subject to the OAL review requirement as a condition of validity. (See Gov.Code, § 11346.) But those, among others, that "[e]stablish[]

or fix[] rates, prices, or tariffs" (*id.*, § 11343, subd. (a)(1)) are excepted. (*See id.*, § 11346.1, subd. (a).)

The Insurance Commissioner has taken the position that the rate regulations come within the rate-setting exception, hence fall outside the OAL review requirement, and therefore are not invalid because of OAL disapproval. He represents that he submitted the regulations in question to the OAL "voluntarily" "in order to provide maximum opportunity for public participation, and in the hope of avoiding any litigation that might accompany his reliance on that" exception.

Let us return to the present proceeding. The focus of the superior court was the Insurance Commissioner's rate regulations as to rollbacks and his order determining 20th Century's rate rollback liability.

A. *The Rate Regulations*

The rate regulations are codified as title 10, chapter 5, subchapter 4.8, articles 1 through 7, sections 2641.1 through 2647.1 of the California Code of Regulations. Insofar as they directly bear on rollbacks, they are included therein as title 10, chapter 5, subchapter 4.8, article 5, sections 2645.1 through 2645.9, and article 6, sections 2646.1 through 2646.5.

At the outset, three general comments are called for.

First, insurance premiums and losses may be accounted for on a cash or accrual basis. Cash accounting speaks of "premiums written" and "losses paid": "premiums written" refers to dollars received; "losses paid" refers to dollars paid out. Accrual accounting, by contrast, speaks of "premiums earned" and "losses incurred": "premiums earned" refers to dollars distributed pro rata over the term of the policy; "losses incurred" refers to both actual pay-outs and reserves set aside for future pay-outs. The rate regulations generally require insurance premiums and losses to be accounted for on an accrual basis, as "premiums earned" and "losses incurred." (See Cal.Code Regs.,

tit. 10, §§ 2643.3, 2644.4, 2644.5, 2644.6, 2644.7, 2645.4, 2645.9.)

Second, an insurer's capital may be measured in accordance with "generally accepted accounting principles" (hereafter sometimes GAAP) or "statutory accounting principles" (hereafter sometimes SAP). Statutory accounting principles are more conservative than generally accepted accounting principles. "Statutory accounting principles . . . are rules that state insurance departments have developed to regulate . . . insurance companies; SAP mandate that conservative methods be employed in valuing the assets of such companies to guarantee their continuing solvency. [Citations.] This routine conservatism as reflected through use of SAP requires only that [*sic*: read, "requires that only"] certain types of assets be considered in calculating a company's financial condition, and that the value of such . . . assets be determined according to quite restrictive rules." (*Meyers v. Moody* (5th Cir. 1982) 693 F.2d 1196, 1218). The rate regulations generally require an insurer's capital to be measured in accordance with statutory accounting principles rather than generally accepted accounting principles. (Cal.Code Regs., tit. 10, § 2643.5).

Third, insurance transactions may be subjected to "direct" or "net" "ratemaking." To quote the Insurance Commissioner: " 'Direct ratemaking' measures the insurer's operations at the 'retail' level, counting all premiums the insurer receives from its policyholders and all losses paid to them. 'Net ratemaking' measures the same operations 'net' of reinsurance—subtracting from premiums the insurer receives from policyholders that portion it passes on ('cedes') to reinsurers and subtracting from losses those amounts covered by ('ceded to') reinsurers." The rate regulations generally require insurance transactions to be subjected to "direct ratemaking." (See Cal.Code Regs. tit. 10, § 2645.9.)

Central to this matter is what is commonly referred to as the "ratemaking formula." (Cal.Code Regs., tit. 10, §§ 2644.2, 2644.3.)

Permitted EP = losses + ALAE + fixed expenses—ancil income

1—var exp *factor—profit factor + invest inc factor*

"Permitted EP" stands for permitted earned premium. (Cal.Code Regs., tit. 10, §§ 2644.2, 2644.3.)

"Losses" means incurred losses that are adjusted as specified. (Cal.Code Regs., tit. 10, §§ 2644.4, 2644.5, 2644.6, 2644.7, 2645.4.)

"ALAE" stands for "allocated loss adjustment expenses," which means the costs associated with the adjustment of specific claims. (Cal.Code Regs., tit. 10, § 2644.8, subd. (a).)

"Fixed expenses" means expenses for acquisition (other than commission and brokerage), field supervision, and collection; plus general expenses; plus state and local taxes, licenses, and fees; minus state premium taxes; plus unallocated loss adjustment expenses—all adjusted as specified. (Cal.Code Regs., tit. 10, § 2644.9.)

"Fixed expenses" are subject to an "efficiency standard" —a test of reasonableness—for each covered line of insurance, as established from time to time by the Insurance Commissioner in a generic determination. (Cal.Code Regs., tit. 10, § 2644.12.) The generic determination applicable to rollbacks is incorporated. (*Id.*, tit. 10, § 2645.5, subds. (b) & (c).)

"Fixed expenses" do *not* include: (a) political contributions and lobbying; (b) executive compensation exceeding a reasonable amount, as found from time to time by the Insurance Commissioner in a generic determination—the generic determination for rollbacks is incorporated (Cal.Code Regs., tit. 10, § 2645.5, subd. (a)); (c) bad faith judgments and allocated loss adjustment expenses; (d) costs attendant to the unsuccessful defense of discrimination claims; (e) fines and penalties; (f) institutional advertising expenses; and (g) payments to affiliates for goods or services exceeding their fair market value. (*Id.*, tit. 10, § 2644.10.)

"Ancil income" stands for "ancillary income," which means net income not derived from operations directly related to covered insurance. (Cal.Code Regs., tit. 10, § 2644.13.)

"Var *exp* factor" stands for "variable expense factor," which means the sum of the commission rate and the state premium tax rate. (Cal.Code Regs., tit. 10, § 2644.14.)

"Profit factor" means the "permitted after-tax rate of return" divided by the product of the "leverage factor" for each line of covered insurance multiplied by the "federal income tax factor." (Cal.Code Regs., tit. 10, § 2644.15.) "Permitted after-tax rate of return" is the yield on investment as established from time to time by the Insurance Commissioner in a generic determination. (*Id.*, tit. 10, § 2644.16.) The generic determination applicable to rollbacks is incorporated as 10 percent, "corresponding to the lower boundary of the range of reasonable [rates of] return[]. . . . (*Id.*, tit. 10, § 2645.6, subd. (a).) "Leverage factor" means the ratio of net written premiums to surplus for each line of covered insurance, as established from time to time by the commissioner in a generic determination. (*Id.*, tit. 10, § 2644.17.) The generic determination of leverage ratios applicable to rollbacks is incorporated. (*Id.*, tit. 10, § 2645.6, subd. (b).) If an insurer's actual leverage ratio or ratios for the rollback year under 1989 calendar year data is higher than the specified leverage ratio or ratios, it is used instead. (*Id.*, tit. 10, § 2645.6, subd. (c).) "Federal income tax factor" means 1 minus the insurer's effective federal income tax rate. (*Id.*, tit. 10, § 2644.18.)

"Invest inc factor" stands for "investment income factor," which means the insurer's yield multiplied by the sum of the "reserves ratio" plus the "surplus ratio." (Cal. Code Regs., tit. 10, § 2644.19.) "Reserves ratio" means (a) the average of the last two years' loss reserves, plus loss adjustment expenses reserves, plus unearned premium reserves, (b) divided by the earned premium for the most recent year for which data are available. (*Id.*, tit. 10,

§ 2644.21.) "Surplus ratio" means the reciprocal of the leverage factor. (*Id.*, tit. 10, § 2644.22.)

The ratemaking formula is designed to yield a premium that the insurer should receive from its insureds in order to earn a sum amounting to (1) the reasonable cost of providing insurance and (2) the capital used and useful for providing insurance multiplied by a fair rate of return. This is consistent with the general rule that the rate set for a regulated firm is the sum of (1) its cost of service and (2) its capital base multiplied by a rate of return. (See, e.g., *Jersey Cent. Power & Light Co. v. F.E.R.C.* (D.C.Cir.1987) 810 F.2d 1168, 1172 (en banc) [hereafter sometimes *Jersey Central*].)[4]

The ratemaking formula incorporates the accounting principle of "matching." Matching involves, inter alia, the consistent treatment of related items of revenue and expenses. Thus, for any given period, one must recognize, for example, an increase in taxes with an increase in premiums and a decrease in taxes with a decrease in premiums. So far as review of rates subject to the rate rollback is concerned, matching operates to take account

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[4] The "used and useful" rule has traditionally been applied in defining the capital base of regulated firms. So too the "prudent investment" rule. "Requiring an investment to be prudent when made is one safeguard imposed by regulatory authorities upon the regulated business for benefit of ratepayers. . . . [T]he 'used and useful' rule is but another safeguard. The prudence rule looks to the time of investment, whereas the 'used and useful' rule looks toward a later time. The two principles are designed to assure that the ratepayers, whose property might otherwise of course be 'taken' by regulatory authorities, will not necessarily be saddled with the results of management's defalcations or mistakes, or as a matter of simple justice, be required to pay for that which provides the ratepayers with no discernible benefit." (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra*, 810 F.2d at p. 1190 (conc. opn. of Starr, J.).) "The 'used and useful' rule operates as a restraining principle, reminding . . . managers that they must assume the risk of economic forces working against an investment which is prudent at the time it is made." (*Id.* at p. 1190, fn. 1 (conc. opn. of Starr, J.).)

of the expenses that would have been avoided had the insurer charged a rate no higher than the maximum rate set by Proposition 103 as construed in *Calfarm*—i.e., the rate that is 80 percent of the 1987 rate *or* such rate greater than 80 percent of the 1987 rate as is minimally nonconfiscatory—as well as the revenue that would have been forgone.

The ratemaking formula defines the values of many of its variables differently for the review of rates subject to the rate rollback and for the review of rates subject to the "prior approval" system.

Because the "prior approval" system concerns rates for the future, its orientation is necessarily prospective. Hence, for review of rates thereunder, the ratemaking formula relies much on projections. (See, e.g., Cal.Code Regs., tit. 10, §§ 2644.2, 2644.3, 2644.4, 2644.8, 2644.9, 2644.13, 2644.20.)

By contrast, because the rate rollback concerns rates for a period that has passed, its orientation is retrospective. Hence, for review of rates thereunder, the ratemaking formula relies much on actual historical data. (See, e.g., Cal.Code Regs., tit. 10, §§ 2645.2, subd. (d), 2645.4, 2645.8.) For convenience, such data is taken largely from the 1989 calendar year instead of the rollback year, which as noted extended from November 8, 1988, through November 7, 1989. (See, e.g., *id.* tit. 10, §§ 2645.4, 2645.6, subd. (c).)

Further, the ratemaking formula is used differently for the review of rates subject to the rate rollback and for the review of rates subject to the "prior approval" system.

Under the "prior approval" system, the insurer is effectively free to set for itself whatever rate it chooses, provided that (as relevant here) its rate is neither "excessive" nor "inadequate."

The rate regulations define as "excessive" a rate that is "expected to yield the reasonably efficient insurer a

profit that exceeds a fair return on the investment used to provide the insurance" in light of the "competing interests of consumers in lower prices and of investors in prices that yield high returns" and the "fact that insurance is imbued with the public interest and is sometimes legally required." (Cal.Code Regs., tit. 10, § 2642.1.) They define as "inadequate" a rate "under which a reasonably efficient insurer is not expected to have the opportunity to earn a fair return on the investment that is used to provide the insurance" in light of the considerations identified above. (*Id.*, tit. 10, § 2642.3.) Lastly, they define a "fair return" as the "profit that an investor can reasonably expect to earn from an investment in a business other than insurance subject to regulation [thereunder] presenting investment risks comparable to the risks presented by insurance subject" thereto. (*Id.*, tit. 10, § 2642.2.)

By contrast, under the rate rollback, the insurer is *not* free to set for itself whatever rate it chooses between the "excessive" and the "inadequate." Rather, it is required to charge a rate no higher than the maximum rate set by Proposition 103 as construed in *Calfarm*—i.e., the rate that is 80 percent of the 1987 rate *or* such rate greater than 80 percent of the 1987 rate as is minimally nonconfiscatory, whichever is higher.

In this regard, the rate regulations set out, among others, the following findings by the Insurance Commissioner:

"Proposition 103 requires that all rates charged during the rollback period be reduced by 20% from their November 8, 1987, levels. Consumers are entitled to receive, and insurers are obligated to give, this reduction, except to the extent that it violates the insurers' constitutional rights." (Cal.Code Regs., tit. 10, § 2645.2, subd. (a).)

"Insurers are entitled to rates during the rollback period that are not confiscatory. Rates are confiscatory if and only if all the rates charged by" the individual in-

surer "are, taken as a whole, confiscatory." (Cal.Code Regs., tit. 10, § 2645.2, subd. (b).)

"To the extent that the rates specified by Proposition 103 for the rollback period are confiscatory, insurers are entitled to a rate above the level prescribed by the initiative, but not higher than necessary for the rates not to be confiscatory." (Cal.Code Regs., tit. 10, § 2645.2, subd. (c).)

To cover both the rate rollback and "prior approval" systems, the ratemaking formula may be used to yield both a *maximum* permitted earned premium (when the profit factor variable takes as its value a maximum profit factor based on a maximum permitted after-tax rate of return (see Cal.Code Regs., tit. 10, §§ 2644.2, 2644.15)) and a *minimum* permitted earned premium (when the profit factor variable takes as its value a minimum profit factor based on a minimum permitted after-tax rate of return (see *id.*, tit. 10, §§ 2644.3, 2644.15).

For review of rates under the "prior approval" system, the Insurance Commissioner determines both the maximum and minimum permitted earned premium. That is because, as stated, the insurer is effectively free to set for itself whatever rate it chooses between the "excessive" and the "inadequate." A rate is "excessive" if it is higher than the maximum permitted earned premium. (See Cal.Code Regs., tit. 10, § 2644.1.) It is "inadequate" if it is lower than the minimum permitted earned premium. (See *ibid.*) The commissioner must approve a rate that (as relevant here) falls between the "excessive" and the "inadequate." (See *ibid.*)

By contrast, for review of rates under the rate rollback, the Insurance Commissioner proceeds otherwise. As stated, the insurer is *not* free during the rollback year to set for itself whatever rate it chooses between the "excessive" and the "inadequate," but rather must charge a rate no higher than the maximum rate set by Proposition 103 as construed in *Calfarm*, i.e., the rate that is 80 percent of the 1987 rate *or* such rate greater than 80 per-

cent of the 1987 rate as is minimally nonconfiscatory. For the rollback year, the commissioner determines only the minimum permitted earned premium, and does so only to define what is minimally above "inadequate" or minimally nonconfiscatory. The insurer must refund to each of its insureds, with simple interest calculated at 10 percent per annum computed from May 8, 1989, the midpoint of the rollback year, through the date of payment, an amount equal to the premiums paid for the rollback year multiplied by the "refund percentage," which means the lesser of (1) the "statutory percentage" (i.e., the larger of (a) total 1989 direct earned premium [excluding surety, credit, and financial guaranty insurance] minus total 1989 direct earned premium [excluding surety, credit, and financial guaranty insurance] adjusted to the rate that is 80 percent of the 1987 rate divided by total 1989 direct earned premium [excluding surety, credit, and financial guaranty insurance], or (b) zero), and (2) the "constitutional percentage" (i.e., the larger of (a) total 1989 direct earned premium [including surety, credit, and financial guaranty insurance] minus the total minimum permitted earned premium [including surety, credit, and financial guaranty insurance] divided by total 1989 direct earned premium [excluding surety, credit, and financial guaranty insurance], or (b) zero). (Cal.Code Regs., tit. 10, § 2645.9.) In the refund calculation, the total minimum permitted earned premium is the sum of the minimum permitted earned premium for each of the covered lines of insurance written by the insurer—the latter functioning only as an intermediate step in the calculation.

Central to this proceeding is not only the ratemaking formula itself, but also the nature and scope of the hearing at which the individual insurer's rates are reviewed.

Concerning the nature of a hearing for review of rates. Such a hearing has two purposes. (Cal.Code Regs., tit. 10, § 2646.4, subd. (b).)

One is to determine whether the insurer has properly applied the relevant statutory and regulatory provisions,

including generic determinations, in calculating the maximum or minimum permitted earned premium. (Cal.Code Regs., tit. 10, § 2646.4, subd. (b)(1).)

The other is to determine whether the resulting maximum or minimum permitted earned premium should be adjusted. (Cal.Code Regs., tit. 10, § 2646.4, subd. (b)(2).) A request for such an adjustment is referred to as a "variance request." (*Ibid.*)

There are eight valid bases for a variance request. (Cal. Code Regs., tit. 10, § 2646.4, subd. (c).)

Only three are applicable to rates under the rate rollback. (Cal.Code Regs., tit. 10, § 2646.4, subd. (d).) They are:

First, the "one-line" variance: "[T]he insurer should be authorized a rate of return" other than 10 percent "on the ground that the insurer writes in only one line and its mix of business presents investment risks different from the risks that are typical of the line as a whole." (Cal. Code Regs., tit. 10, § 2646.4, subd. (c)(4).)

Second, the "entering-the-market" variance: "[T]he insurer should be granted relief from operation of the efficiency standard for a line of insurance in which the insurer has never previously written over $1 million in earned premium annually and in which the insurer has made or is making a substantial investment in order to enter the market. . . ." (Cal.Code Regs., tit. 10, § 2646.4, subd. (c)(5).)

And third, the "insurer-insolvency" variance: "[T]he insurer's financial condition is such that its maximum permitted earned premium should be increased in order to protect the insurer's solvency. . . ." (Cal.Code Regs., tit. 10, § 2646.4, subd. (c)(8).)

Concerning the scope of a hearing for review of rates: "Relitigation in a hearing on an individual insurer's rates of a matter already determined either by these regulations or by a generic determination is out of order and shall not be permitted. However, the administrative law judge

shall admit evidence he or she finds relevant to the determination of whether the rate is excessive or inadequate (or, in the case of a proceeding [concerning a rate for the rollback year], relevant to the determinaton of the minimum nonconfiscatory rate), whether or not such evidence is expressly contemplated by these regulations, provided the evidence is not offered for the purpose of relitigating a matter already determined by these regulations or by a generic determination." (Cal.Code Regs., tit. 10, § 2646.4, subd. (e).) This is commonly referred to as the "relitigation bar."

B. *The Insurance Commissioner's Determination of 20th Century's Rate Rollback Liability*

Let us now turn from the Insurance Commissioner's rate regulations to his determination of 20th Century's rate rollback liability.

It appears that a week after we handed down *Calfarm*, the Insurance Commissioner's predecessor gave public notice that insurers who wished to do so could file applications for approval of rates for the rollback year higher than the maximum rate of 80 percent of the 1987 rate (hereafter "rollback exemption" applications), and could charge such higher rates pending approval.

It further appears that 20th Century filed seven "rollback-exemption" applications and proceeded to charge the indicated higher rates—which seem to have been about 12.63 percent greater than the 1987 rate—pending approval. The firm writes six lines of insurance.

Subsequently, in File No. REB-5173 the Insurance Commissioner issued an order to show cause and notice of hearing in the matter of 20th Century's rate rollback liability. The commissioner indicated that 20th Century should refund to each insured an amount equal to the premiums paid for the rollback year multiplied by a refund percentage of 13.34 percent, with simple interest calculated at 10 percent per annum from May 8, 1989, to the date of payment.

A hearing on the Insurance Commissioner's order to show cause was held before an administrative law judge. The hearing was extensive. In her own words, the administrative law judge considered "hundreds of pages of prefiled testimony and detailed exhibits as well as several weeks of live testimony, posthearing briefs and oral argument. . . ."

The administrative law judge issued a proposed decision that fills 185 pages. Evidently for the purpose of subsequent judicial review, she effectively lifted the "relitigation bar" to allow 20th Century to introduce evidence to challenge the premises of the rate regulations, "accord[ing] it the opportunity to present evidence . . . on every issue that it contended was material." She also recognized a constitutionally mandated "variance"—separate and indipendent from those established in the regulations in question—which would be available to 20th Century on proof of confiscation, for which she allowed "evidence and argument on whether the rollback formula . . . yielded unconstitutional and confiscatory results as applied to 20th Century" and thereby "justif[ied] or requir[ed] departure from the regulations. . . ." As pertinent here, her determinations were to the following effect.

During 20th Century's rollback liability hearing, the rate regulations were in effect, notwithstanding the OAL's disapproval at various times.

Proposition 103 authorizes the Insurance Commissioner to adopt rate regulations to implement the rate rollback requirement provision. "The regulations," explained the administrative law judge, "avoid the administrative gridlock that would result from readjudicating over and over hundreds of issues that affect multiple insurers in lengthy hearings that would yield inconsistent results—*if* they ever yielded any result at all." (Italics added in place of underscoring in original.) "The regulations employ generic determinations and a detailed formula designed to ensure manageability and consistent treatment of insurers and insureds." "At the same time, the regulations incorporate

multiple company-specific factors into the rollback formula, and then are applied in individual adjudicatory hearings. The company-specific hearings allow further tailoring to a company's situation. . . ."

Specifically, Proposition 103 authorizes the Insurance Commissioner to adopt rate regulations to implement the rate rollback requirement provision with a view toward factors including the individual insurer's profits and not—as 20th Century claims he must—through the imposition of general "price caps" on the rates of insurers generally. 20th Century's rates for the rollback year might survive the imposition of such "price caps" because they were relatively low—reflecting its relatively low costs: it is a direct writer of insurance, and therefore does not employ or utilize captive or independent agents; and it is very selective as to its insureds, choosing preferred risks. But, observed the administrative law judge, 20th Century's argument for regulation by "price caps" rather than factors including profits is bottomed on "policy" rather than law —specifically, a "policy" that "would have us ignore *Calfarm's* emphasis on" such factors as profits "and Proposition 103's call for reduction of rates industry-wide," "regardless of whether the rates were low or high by industry standards. . . ." (Italics added in place of underscoring in original.) Confiscation requires at least "deep financial hardship"—albeit "deep financial hardship" *short of bankruptcy*—within the meaning of *Jersey Central.* (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at p. 1181, fn. 3.) Moreover, it "is an enterprise-wide issue, not one to be parsed on a line-by-line basis." Under the rate rollback requirement provision—to use the terms appearing in Insurance Code section 1861.05, subdivision (a)—a rate is "inadequate" if confiscatory and "excessive" if more than minimally nonconfiscatory and above 80 percent of the 1987 rate.

Proposition 103 authorizes the Insurance Commissioner to adopt a ratemaking formula to implement the rate rollback requirement provision. Specifically, it empowers him

to frame a ratemaking formula to determine whether, for an individual insurer, a maximum rate for the rollback year higher than 80 percent of the 1987 rate is required to avoid confiscation and, if so, what such higher maximum rate is.

Substantively, the rate regulations are valid on their face as necessary and proper for the implementation of Proposition 103's rate rollback requirement provision.

Specifically, the rate regulations are sound insofar as they define 10 percent as the lower boundary of the range of reasonable rates of return in the ratemaking formula. The administrative law judge stated that the 10 percent rate of return was based "on the average historical rates of return actually achieved by the industry between 1980 and 1989, rather than theoretical investor expectations determined by econometric models." She noted that the "industry earned an average 9.1% return . . . in 1989" under statutory accounting principles, and that "over the 10 years from 1980 to 1989 averaged a 10% return" under both statutory accounting principles and generally accepted accounting principles. (Internal quotation marks omitted.) She concluded that "[u]se of actual historical rates of return rather than inherently speculative hypothetical projections of investor expectations is . . . reasonable . . ., particularly for a time period now already past." The ratemaking formula, it must be noted, does not purport to guarantee any individual insurer a rate covering its cost of service plus 10 percent of its capital base independent of the various adjustments, exclusions, etc., incorporated therein. There is no constitutional or other requirement that all reasonable expenses and prudent investments must be allowed.

The rate regulations are also sound insofar as they recognize investment income in the ratemaking formula. "[U]nlike other businesses such as public utilities," observed the administrative law judge, "insurers need not transform their capital into physical assets like a power

plant, but may keep them instead in liquid assets like stocks and bonds. Surplus may simultaneously support the insurance business and earn investment income."

The rate regulations are sound as well insofar as they concern the line of earthquake insurance, which is of particular interest because the Loma Prieta earthquake struck Northern California during the rollback year. They subject all insurers to consistent treatment, including direct ratemaking—which is used to avoid a possible loophole since reinsurance is generally not regulated (Ins.Code, § 1851, subd. (a)). They yield generally supportable outcomes for individual insurers, although they disfavor those whose incurred losses are small and favor those whose incurred losses are large. In any event, they do not themselves determine the insurer's rate rollback liability. The minimum permitted earned premium for the earthquake line must not be viewed in isolation as an end result. Together with the minimum permitted earned premium for each of the insurer's other lines, it functions only as an intermediate step in the refund calculation.

With specific regard to direct ratemaking, the administrative law judge observed: The Insurance Commissioner's adoption of "direct ratemaking as a consistent basis for determining rollback obligations" is a "reasonable policy choice. . . ." One of 20th Century's witnesses "admitted that 20th Century, like the industry generally," uses direct ratemaking. He also "agreed that as a matter of policy the Commissioner should adopt a consistent basis for all insurers and that direct ratemaking would greatly benefit companies with large reinsured losses like those who paid claims due to the Loma Prieta earthquake." He "acknowledged" that "most insurers benefit from use of the direct basis since they had large losses ceded to reinsurance in 1989 due to the Loma Prieta earthquake . . ., and those recoveries from reinsurers are not recognized on a direct basis. Therefore, the uniform use of direct rather than net ratemaking was more favorable to the industry as a whole, while placing the higher rollback obligation on those with

low losses and thus better able to pay it." "Further, while 20th Century's argument that direct ratemaking is unfair because it ignores money actually paid to purchase reinsurance in 1989 has some appeal at first blush, it ignores the fact that any set of accounting rules necessarily includes conventions which in a sense deviate from actual expenditures. Indeed, 20th Century benefits from the regulations' recognition of 1989 reserves as if those amounts were actually paid, when in fact the claims covered by reserves were actually paid after 1989." Surely, "losses are a major component" in the rate regulations—both generally and specifically as to rollbacks. But that is simply "because the nature of the insurance business is to indemnify losses."

The rate regulations are also sound insofar as they require a uniform, maximum rate for the rollback year, and a uniform percentage refund of premiums overcharged and overpaid therein, without regard to claimed "excessiveness" or "inadequacy" in individual lines.

Further, the rate regulations are not impermissibly "rettroactive."

Procedurally, the rate regulations are valid on their face as necessary and proper for the implementation of Proposition 103's rate rollback requirement provision. Specifically, they are sound insofar as they provide for a hearing on an individual insurer's rate rollback liability. They do not preclude an "individualized" hearing by reason of the nature or number of the potentially available variances, viz., the "one-line," "entering-the-market," and "insurer-insolvency" variances. Neither do they preclude an "individualized" hearing by reason of the "relitigation bar."

Moreover, substantively and procedurally, the rate regulations are valid as necessary and proper for the implementation of Proposition 103's rate rollback requirement provision as applied to 20th Century.

The operation of the ratemaking formula with its variables deriving their values from firm-specific data neces-

sarily afforded 20th Century whatever rate adjustment was necessary to avoid confiscation. The hearing thereon was "individualized" and altogether full and fair.

Further, 10 percent as the lower boundary of the range of reasonable rates of return is not confiscatory as to 20th Century.

20th Century introduced evidence in an attempt to establish its entitlement to a rate of return of at least 20 percent and perhaps as high as 99 percent. The evidence related to 20th Century's cost of capital.[5] "Cost of capital" may be defined as the rate of return available in the marketplace on investments comparable in terms of risk and otherwise or, more practically, as the expected rate of return a hypothetical investor would require to take a position in the firm in question. Specifically, the evidence looked to 20th Century's cost of capital derived from various econometric models directed toward the "optimal prospective rate of return based on hypothetical investor expectations."

20th Century's cost-of-capital evidence was deemed immaterial by the administrative law judge. The adjective "optimal" is inapt: Under Proposition 103 as construed in *Calfarm*, for the rollback year the Insurance Commissioner "must select a rate at or near the bottom of the range of rates which are constitutional. Yet [20th Century] has ignored the lower end of the range, instead focusing exclusively on the highest rate of return that might conceivably be expected by investors in 1989." Also inapt is the adjective "prospective": "While estimated returns are pertinent for prospective ratemaking [under

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[5] 20th Century is a "stock insurance company," i.e., a "private corporation that engages in the insurance business. As is generally true of private corporations, an insurer which is organized in this way is owned by investors (usually described as shareholders) who receive the profits, if any, through dividends." (Keeton & Widiss, Insurance Law, *supra*, § 2.1(a)(2), p. 33.) As a stock insurance company, 20th Century is apparently an exception among insurers.

the "prior approval" system], implementation of the rollback does not require prospective ratemaking but rather the determination of a minimum nonconfiscatory return for a period now past." (Internal quotation marks omitted.)

20th Century's cost-of-capital evidence was also deemed unpersuasive by the administrative law judge. One of 20th Century's main expert witnesses "testified to a constitutionally required rate of return (ultimately 33 percent, earlier 41.5 percent, and even higher when he initially advocated more than doubling his figures) that exceeds 20th Century's actual rate of return" of about 31.51 percent under statutory accounting principles and 32.52 percent under generally accepted accounting principles.

Neither is any of the following confiscatory as to 20th Century: the treatment of the line of earthquake insurance, including direct ratemaking; the variable expense factor; the leverage factor; or the requirement of a uniform, maximum rate for covered insurance for the rollback year, and a uniform percentage refund of premiums overcharged and overpaid therein, without regard to claimed "excessiveness" or "inadequacy" in individual lines.

As to the treatment of the line of earthquake insurance, including direct ratemaking, the administrative law judge observed: "The component of the rollback calculation related to 20th Century's Earthquake line may appear somewhat harsh when it is viewed in isolation . . ., as if it were the final result rather than only an intermediate step in the calculation. However, 20th Century's rollback must be judged on the issue of confiscation based on the overall result. [Citation.] From that perspective, the impact is not confiscatory. [Citation.] 20th Century is a multi-line insurer whose Earthquake line accounted for only 1.35 percent of its business ($8.7 million of $641.7 milion) in the rollback year, and its unrecognized reinsurance premiums on Earthquake only accounted for 0.7 percent of its business ($4.5 million of $641.7 million).

[Citation.] It admittedly suffered very low losses in its Earthquake line that year [because of its concentration in sounthern California, which did not experience the Loma Prieta earthquake] and its cost of writing that coverage was small (estimated . . . to be as low as five dollars per policy, [citation]), so it enjoyed a high profit in that line. In any case, calculation of the Earthquake component of the rollback is merely one of the many intermediate steps to the final rollback." (Fn. omitted.)

As to the leverage factor, the administrative law judge observed: "For rollback, the regulations use whichever is higher, the actual leverage ratio that the insurer had in the rollback year or a specified ratio." (For the "prior approval" system, by contrast, they use a specified leverage ratio, even if the actual ratio is higher.) 20th Century "contends that for the rollback year it should be permitted to earn a profit on a higher level of surplus (i.e., lower leverage or premium-to-surplus ratio) than it actually had that year, because as a more highly leveraged company, it was riskier and therefore entitled to a higher rate of return." This "contention boils down to an unjustfiable request to earn a profit on capital that it did not have." In addition, 20th Century "omits the corollary to its argument that its stockholders deserve a higher return because of the greater risk entailed by [its] high leverage ratio: that policyholders who purchased its insurance for security and peace of mind shared in this higher risk, and probably did so involuntarily."

Implicit in the administrative law judge's observation is a recognition that the leverage factor is crucial to the determination of rates. As stated, the ratemaking formula is designed to yield a premium that the insurer should receive from its insureds in order to earn a sum amounting to (1) the reasonable cost of providing insurance and (2) the capital used and useful for providing insurance multipled by a fair rate of return. The leverage factor directly contributes to the definition of the capital that is deemed used and useful for providing insurance by inverse

relationship: the higher the leverage ratio, the smaller the used-and-useful capital; the lower the leverage ratio, the greater the used-and-useful capital. It follows that the leverage factor indirectly contributes to the setting of the rate itself by inverse relationship: the higher the leverage ratio, the smaller the used-and-useful capital and hence the smaller the rate; the lower the leverage ratio, the greater the used-and-useful capital and hence the greater the rate. Thus, so far as the determination of rates is concerned, the insurer generally favors a lower leverage ratio and its insureds generally favor a higher leverage ratio. The nonrecognition of capital that "turn[s] out not to be 'used and useful' is not confiscatory," observed the administrative law judge, no matter the prudence of the underlying investment.

The administrative law judge concluded: "Nowhere in the hundreds of pages of testimony, exhibits and argument that 20th Century has proffered in support of its argument of confiscation has it claimed that its rollback would pose the type of deep financial hardship . . . that rises to the level of confiscation. At most, it has argued that it would not be able to expand as rapidly as it has in the past because its reduced surplus after a rollback would not support as large a growth in premiums written. [Citations.] Even assuming that this were true, 20th Century has cited no case holding that a slowdown in growth is confiscatory. The clear evidence that 20th Century has been able to expand rapidly largely through use of retained earnings, selling stock only once in the last six years while growing from a $500 million to a $1 billion company [citation], undercuts 20th Century's claim that it will not be able to raise new surplus if forced to rollback. Moreover, to the extent that 20th Century has already set aside reserves against its rollback liability, with a corresponding reduction in surplus, the impact of that reduction has already occurred. [Citation.] Yet 20th Century has continued to grow by more than 10 percent each year from 1989 through 1991." (Fn. omitted.)

The Insurance Commissioner adopted the administrative law judge's proposed decision as his own. In accordance therewith, he ordered 20th Century to refund to each insured an amount equal to the premiums paid for the rollback year multiplied by a refund percentage of 12.203 percent, with simple interest calculated at 10 percent per annum from May 8, 1989, to the date of payment. In so doing, he effectively set 20th Century's maximum rate for the rollback year at about 98.89 percent of the 1987 rate to avoid confiscation, rather than at 80 percent of that rate, as required by Proposition 103 in the rate rollback requirement provision. Put differently, he reduced 20th Century's maximum rate for the rollback year to a point a mere 1.11 percent below the 1987 rate, rather than to a point 20 percent below that rate.

The Insurance Commissioner's decision on the rate rollback liability of 20th Century is the first and only final determination of this sort. The commissioner chose the 20th Century matter as a "test case," in part because of its relative simplicity. It appears that more determinations of rate rollback liability will follow: The commissioner represents that about 460 insurers have filed over 4,000 "rollback-exemption" applications, and have proceeded to charge the indicated higher rates.[6]

C. *The Superior Court's Decision*

After a bench trial, the superior court filed its statement of decision herein, which fills 85 pages. It limited its scope to the rate regulations as to rollbacks and the 20th Century rate rollback order. It found and concluded to the following effect.

The litigation is not moot. The rate regulations were in effect during 20th Century's rate rollback liability hearing and were applied to determine its rate rollback liability, as

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[6] In *Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at page 941, the court put the number of insurers at 460 and the number of "rollback-exemption" applications at 4,089.

expressed in the rate rollback order. 20th Century has challenged both the regulations and the order. The latter stands. Whether or not the former are in effect—or were in effect at times other than 20th Century's rollback hearing—is of no consequence here. It was noted that the Insurance Commissioner had taken the position that the rate regulations come within the rate-setting exception, hence fall outside the OAL review requirement, and therefore are not invalid because of OAL disapproval. Whether his position was well taken was not resolved.

Various standards of review are applicable. At the threshold, whether Proposition 103 authorizes the Insurance Commissioner to adopt rate regulations to implement the initiative, specifically the rate rollback requirement provision, is examined independently. Next, whether the rate regulations actually adopted by the commissioner as to rollbacks are consistent with the measure is also examined independently. By contrast, whether the rate regulations actually adopted by the commissioner as to rollbacks are necessary and proper for the initiative's implementation is scrutinized for arbitrariness and/or capriciousness. Finally, in reviewing the 20th Century rate rollback order issued by the commissioner, the court is required to weigh the evidence in accordance with its independent judgment and then to sustain the decision if it finds adequate evidentiary support and to strike it down if it does not.

Under independent review, the rate regulations as to rollbacks are not invalid on their face as statutorily unsupported. Proposition 103 authorizes the Insurance Commissioner to adopt rate regulations to implement the rate rollback requirement provision. More particularly, it empowers him to define "unreasonable or imprudent expenses [or investments]," the relevant capital base, and a rate of return applicable thereto corresponding to the lower boundary of the range of reasonable rates of return.

Nevertheless, under independent review, the rate regulations as to rollbacks are invalid on their face with respect

to the ratemaking formula. Proposition 103 does not authorize the Insurance Commissioner to adopt a ratemaking formula to implement the rate rollback requirement provision. To begin with, the initiative does not empower the commissioner to frame any ratemaking formula whatsoever. It does not permit him to set rates himself. Rather, as a general matter, it allows him merely to approve or disapprove rates proposed by individual insurers, applying (as relevant here) the "excessive"/"inadequate" standard. As to rollbacks specifically, it requires him to approve any proposed rate that is minimally above the "inadequate" and to disapprove any other, even if such other rate falls at some other point below the "excessive." (Under the rate rollback requirement provision —to use the terms appearing in Insurance Code section 1861.05, subdivision (a)—a rate is "inadequate" if confiscatory and "excessive" if more than minimally nonconfiscatory and above 80 percent of the 1987 rate.) Further, it would not empower him to frame the ratemaking formula in question. That formula is "recursive." It is also "unique" and without "precedent" among "similar statutes containing the widely used" "excessive"/"inadequate" standard. In addition, it is internally inconsistent: through operation of the efficiency standards, the variable expense factor, and the leverage factor, it precludes a rate covering the individual insurer's cost of service plus 10 percent of its capital base—a 10 percent rate of return on the capital base being defined as the lower boundary of the range of reasonable rates of return. Through such preclusion, the formula is also confiscatory. Confiscation does not require "deep financial hardship" within the meaning of *Jersey Central.* Rather, it arises whenever a rate does not "produce[] a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital."

In view of the foregoing, the rate regulations as to rollbacks are invalid in relevant part and the 20th Century rate rollback order, issued pursuant thereto, is void.

In the event an appellate court might disagree, the superior court resolved other significant issues as follows.

Under the arbitrary-or-capricious standard, the rate regulations as to rollbacks are not invalid on their face insofar as they require that an insurer's capital be measured in accordance with statutory accounting principles or SAP, which apparently operate to limit the capital base to capital used and useful for providing insurance. In this regard, they are necessary and proper for the implementation of Proposition 103's rate rollback requirement provision. The superior court stated that the Insurance Commissioner could reasonably have concluded that insureds "need not provide a return on capital which is not required for insurance business." It implied that he could reasonably have concluded as well that insureds need not provide a return on capital that is not actually employed for that purpose.

Under the arbitrary-or-capricious standard, the rate regulations as to rollbacks are not invalid on their face insofar as they define 10 percent as the lower boundary of the range of reasonable rates of return. In this regard, they are necessary and proper for the implementation of Proposition 103's rate rollback requirement provision. The superior court observed: "It is really rather obvious from the record herein that all [econometric] models can be manipulated/applied to produce a great range of rates of return."

Under (apparently) independent review, the rate regulations as to rollbacks are invalid on their face insofar as they treat the line of earthquake insurance as they do. Proposition 103 does not authorize the Insurance Commissioner to adopt regulations of this sort to implement the rate rollback requirement provision. The regulations in question are unsound in that they subject insurers to direct ratemaking, which does not recognize a firm's expenses for reinsurance, even if reasonable. In this regard —the superior court implied—they offend the United

States and California Constitutions, specifically their respective takings and due process clauses. The regulations in question are also unsound in that they depend in substantial part on the individual insurer's incurred losses for the rollback year. In this regard—the superior court implied—they violate the initiative's proscription of "inadequate" rates in Insurance Code section 1861.05, subdivision (a): calculations are based on loss data from a single year; calculations for the earthquake line, however, should be based on loss data from more than one year, because this line (along with others) is one with losses of "low-frequency" but "high-severity"; calculations for the earthquake line, if based on loss data from a single year with relatively small losses, are skewed to the confiscatory.

Under (apparently) independent review, the rate regulations as to rollbacks are invalid on their face insofar as they incorporate the leverage factor. Proposition 103 does not authorize the Insurance Commissioner to adopt regulations of this sort to implement the rate rollback requirement provision. Indeed—the superior court effectively declared—the United States and California Constitutions stand in prohibition, specifically, their respective takings and due process clauses: "[L]everage reflects risk. The Commissioner recognizes this as to prospective rates by allowing more highly leveraged insurers to use [a lower] 'normative leverage factor' rather than [their] actual [higher] leverage. The result is a higher allowed rate of return to compensate such insurer[s] for [their] greater risk.[7] No such normative factor applies to rollbacks. . . . [Hence,] a significant amount of actual 'proper' 1989 surplus" is "disallow[ed] or disregard[ed]. . . . This result is confiscatory on its face."

Under (apparently) independent review, the rate regulations as to rollbacks are invalid on their face insofar as they preclude an "individualized" hearing on an in-

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[7] "The result," to be accurate, is not a "higher allowed *rate of return*," but rather a "higher allowed *return*."

dividual insurer's rate rollback liability. Proposition 103 does not authorize the Insurance Commissioner to adopt regulations of this sort to implement the rate rollback requirement provision. Indeed—the superior court effectively declared—the United States and California Constitutions stand in prohibition, specifically their respective takings and due process clauses. The regulations in question are "preclusive" in the following two respects. First, the regulations do not allow a variance or variances sufficient for rate adjustments necessary to avoid confiscation: the only potentially available variances are inadequate, each separately and all together—the "one-line" variance is too narrow; the "entering-the-market" variance is the same; and the "insurer-insolvency" variance is too demanding. Second, the regulations impose the "relitigation bar," which assertedly operates to prevent proof of confiscation in and of itself (including the lower boundary of the range of reasonable rates of return), even if there were a sufficient variance or variances. As stated, confiscation does not require "deep financial hardship" within the meaning of *Jersey Central.*

Under independent review, the rate regulations as to rollbacks are not invalid on their face insofar as they require a uniform, maximum rate for the rollback year, and a uniform percentage refund of premiums overcharged and overpaid therein, without regard to claimed "excessiveness" or "inadequacy" in individual lines. Proposition 103 authorizes the Insurance Commissioner to adopt rate regulations of this sort to implement the rate rollback requirement provision.

Under independent review, the rate regulations as to rollbacks are not invalid on their face insofar as they require the insurer to pay interest on the dollar amount of premiums overcharged and overpaid for the rollback year. Proposition 103 authorizes the Insurance Commissioner to adopt rate regulations of this sort to implement the rate rollback requirement provision. Indeed, as construed in *Calfarm,* it enjoins him to demand payment of interest:

"insurer[s] must refund excess premiums collected [for the rollback year] *with interest.*" (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 825, 258 Cal.Rptr. 161, 771 P.2d 1247, italics added.) Also, under the arbitrary-or-capricious standard, the rate regulations as to rollbacks are not invalid on their face insofar as they fix the rate of interest at 10 percent per annum, uncompounded. In this regard, they are necessary and proper for the initiative's implementation: "It is not unreasonable or arbitrary"—according to the superior court—"for the Commissioner to choose the same rate for rollbacks" that the Legislature chose for unearned premiums in Insurance Code section 481.5; he is not constrained by article XV, section 1 of the California Constitution, which in relevant part provides for a maximum rate of interest on a judgment of 10 percent, if set at that level by the Legislature, or 7 percent, in the absence of action by the Legislature; the constitutional provision "is inapplicable to the insurer's obligation to pay interest on rollbacks because that obligation can hardly be viewed as a 'judgment' "; furthermore, in Code of Civil Procedure section 685.010 the Legislature has in fact set the rate of interest on a judgment at 10 percent. Finally, under the arbitrary-or-capricious standard, the rate regulations as to rollbacks are not invalid on their face insofar as they set the accrual date at May 8, 1989, the midpoint of the rollback year. In this regard too, they are necessary and proper for the initiative's implementation: "Arguably"—according to the superior court—"the Commissioner could have chosen the beginning of the rollback year as the accrual date. The choice of the midpoint is certainly fair to all."

Under the independent-judgment-on-the-evidence standard, the rate regulations as to rollbacks are invalid as applied to 20th Century, and the 20th Century rate rollback order issued pursuant thereto is void, in the following six particulars. First is the rate-making formula itself. Second is 10 percent as the lower boundary of the range of reasonable rates of return: at least 20 percent is the appropriate figure for 20th Century. Third is the treat-

ment of the line of earthquake insurance: 20th Century is subjected to direct ratemaking, which does not recognize the firm's reasonable expenses for reinsurance for the rollback year; moreover, the firm experiences an insupportable outcome, inasmuch as it is treated unfavorably because its incurred losses for the rollback year were small. Fourth is the variable expense factor. Fifth is the leverage factor. Sixth is the preclusion of an "individualized" hearing on rate rollback liability—included therein is a finding of fundamental unfairness in the conduct of the hearing. It appears that the foregoing determinations have constitutional and statutory bases, involving as to the latter offense to Proposition 103 and as to the former confiscation and arbitrariness, discrimination, and demonstrable irrelevance to legitimate policy. At the same time, the rate regulations as to rollbacks are not invalid as applied, and the order issued pursuant thereto is not void, as to the requirement of a uniform, maximum rate for the rollback year, and a uniform percentage refund of premiums overcharged and overpaid therein, without regard to claimed "excessiveness" or "inadequacy" in individual lines. It appears that the foregoing determination was made under constitutional and statutory principles, implying a finding of no offense to Proposition 103 and no confiscation or arbitrariness, discrimination, or demonstrable irrelevance to legitimate policy.

In accordance with its statement of decision, the superior court rendered judgment in favor of 20th Century, Allstate, Hartford, State Farm et al., and against the Insurance Commissioner and Voter Revolt. Specifically, it ordered, adjudged, and decreed that: (1) certain of the rate regulations as to rollbacks are invalid, viz., the ratemaking formula as such and many of its individual components (Cal.Code Regs., tit. 10, §§ 2644.3, 2644.12, 2644.15, 2645.3, subd. (a), 2645.5, subds. (b) & (c), 2645.6, subds. (b) & (c)), the "relitigation bar" (*id.*, tit. 10, § 2646.4, subd. (e)), and the "insurer-insolvency" variance (*id.*, tit. 10, § 2646.4, subd. (c)(8)); and (2) a peremptory writ of mandate should issue commanding

the commissioner to (a) set aside the 20th Century rate rollback order, (b) reconsider the matter in light of the superior court's decision, and (c) refrain from enforcing the regulations referred to above or any order made pursuant thereto. The superior court also caused issuance of the described peremptory writ of mandate.

The Insurance Commissioner and Voter Revolt filed separate notices of appeal. 20th Century, Allstate, and Hartford together with other insurers including State Farm, filed separate notices of cross-appeal. The appeals and cross-appeals were docketed in the Court of Appeal, Second Appellate District, in No. B074704.

Thereupon, the Insurance Commissioner and Voter Revolt filed separate petitions requesting predecision transfer to this court. 20th Century, Allstate, Hartford, and State Farm filed separate answers, supporting (20th Century, Hartford, and State Farm) or at least not opposing (Allstate) the requests. The commissioner also submitted a petition for writ of supersedeas. Allstate, Hartford, and State Farm submitted separate answers in opposition. Concluding that it was premature to consider supersedeas unless and until we ordered transfer, we declined to file any of these pleadings.

Subsequently, we ordered transfer. At the same time, effectively filing the relevant petition and answers, we denied supersedeas.

III. DISCUSSION

In their appeal, the Insurance Commissioner and Voter Revolt and amici curiae supporting their position (hereafter collectively the Insurance Commissioner or the commissioner) raise numerous claims of error regarding the decision of the superior court. In their cross-appeal, 20th Century, Allstate, and Hartford together with other insurers and amici curiae supporting their position (hereafter collectively the insurers) raise numerous claims of their own.[8]

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[8] Consumers Union, appearing as amicus curiae supporting the Insurance Commissioner's position, has requested us to take judi-

A. *Mootness*

At the threshold, the superior court determined that the litigation is not moot. Neither the Insurance Commissioner nor the insurers contend that there was error in this regard. Rightly so.

We agree with the superior court that the rate regulations as to rollbacks were in effect at the time of 20th Century's rate rollback hearing and were applied to de-

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cial notice of the contents of certain "flyers" purportedly distributed during the Proposition 103 campaign, one allegedly by Voter Revolt, the other allegedly by the California State Automobile Association. There is no opposition. Nevertheless, we decline the request. Consumers Union has failed to persuade us that the contents of either of these documents must, or even may, be judicially noticed. (See Evid.Code, §§ 450, 451, 452.) We note in passing, however, that the matters embraced therein are in fact reflected in the record. Hence, we consider them in our analysis.

State Farm, in conjunction with a brief amicus curiae supporting the insurers' position, has requested us to take judicial notice of the contents of certain excerpts from Best's Aggregates & Averages, Property—Casualty (51st ed. 1990), and Best's Insurance Reports, Property—Casualty (1992). We may, of course, "take judicial notice of" (Evid.Code, § 459, subd. (a)) "[f]acts and propositions that are not reasonably subject to dispute and are capable of immediate and accurate determination by resort to sources of reasonably indisputable accuracy" (*id.*, § 452, subd. (h)). There is no opposition. We grant the request. The contents of both of these documents constitute facts of the kind required. (Cf. *Redevelopment Agency v. Gilmore* (1985) 38 Cal.3d 790, 806, 214 Cal.Rptr. 904, 700 P.2d 794 [holding in substance that the contents of such documents as Moody's Investors Service and the Federal Reserve Bulletin "are subject to judicial notice" under Evid.Code, § 452, subd. (h)].) We accept State Farm's representation that "[p]articipants in the [insurance] industry . . . commonly rely on Best's as an accurate factual source and it is well accepted as an accurate and authoritative source of insurance data."

After the completion of briefing and before the holding of oral argument, Allstate and related insurers requested us to dismiss them as parties to this proceeding on the ground that they had reached a settlement with the Insurance Commissioner. We granted the request.

termine its rate rollback liability, as expressed in the rate rollback order, and that 20th Century has challenged both the regulations and the order.

We go beyond the superior court, however, in the following regard. We believe that the Insurance Commissioner's position, as noted above, is well taken. The rate regulations—both generally and specifically as to rollbacks—do indeed come within the rate-setting exception, hence fall outside the OAL review requirement, and therefore are not invalid because of OAL disapproval. (Cf. *State Comp. Ins. Fund v. McConnell* (1956) 46 Cal.2d 330, 343, 294 P.2d 440 [arriving at a similar conclusion under a similar, predecessor legislative scheme (see, e.g., Gov.Code, former § 11380, subd. (a)(1), Stats.1953, ch. 1362, § 1, p. 2933; Gov.Code, former § 11421, subd. (a), Stats.1953, ch. 515, § 1, p. 1755) as to certain "regulations" adopted by the Insurance Commissioner "fixing and establishing insurance premium rates" for workers' compensation insurance]; see also *California Assn. of Nursing Homes etc., Inc. v. Williams* (1970) 4 Cal.App.3d 800, 821, 85 Cal.Rptr. 735 [effectively distinguishing *McConnell* with regard to a regulation adopted by the Director of Health Care Services providing for reimbursement to nursing and convalescent homes for medical assistance rendered to persons covered by the Medi-Cal program].)

B. *Standards of Review*

Before we undertake to review the substance of the superior court's decision, we must determine what standard of review is appropriate. We may summarize the governing principles thus.

"Questions of fact concern the establishment of historical or physical facts; their resolution is reviewed under the substantial-evidence test. Questions of law relate to the selection of a rule; their resolution is reviewed independently. Mixed questions of law and fact concern the application of the rule to the facts and the consequent determination whether the rule is satisfied. If the per-

tinent inquiry requires application of experience with human affairs, the question is predominantly factual and its determination is reviewed under the substantial-evidence test. If, by contrast, the inquiry requires a critical consideration, in a factual context, of legal principles and their underlying values, the question is predominantly legal and its determination is reviewed independently." (*Crocker National Bank v. City and County of San Francisco* (1989) 49 Cal.3d 881, 888, 264 Cal. Rptr. 139, 782 P.2d 278.)

It is plain that the decision of the superior court is subject to independent review. Considered as a whole, it amounts to the resolution of a congeries of questions of law and mixed questions of law and fact that are predominantly legal, including of course that of confiscation. De novo scrutiny is proper. In its parts, it embraces the resolution of questions of law and mixed questions of law and fact that are predominantly legal. Again, de novo scrutiny is proper.

After independent review, we believe that the superior court's determination of the standards of review appropriate to its task was correct.

That is to say, whether Proposition 103 authorizes the Insurance Commissioner to adopt rate regulations to implement the initiative is indeed examined independently. (See, e.g., *California Assn. of Psychology Providers v. Rank* (1990) 51 Cal.3d 1, 11-12, 270 Cal.Rptr. 796, 793 P.2d 2; *Association for Retarded Citizens v. Department of Developmental Services* (1985) 38 Cal.3d 384, 390-391, 211 Cal.Rptr. 758, 696 P.2d 150.)

Whether the rate regulations actually adopted, including the incorporated generic determinations, are consistent with Proposition 103—and with the law generally—is also examined independently. (See, e.g., *California Assn. of Psychology Providers v. Rank, supra*, 51 Cal.3d at pp. 11-12, 270 Cal.Rptr. 796, 793 P.2d 2; *Association for Retarded Citizens v. Department of Developmental*

Services, supra, 38 Cal.3d at pp. 390-391, 211 Cal.Rptr. 758, 696 P.2d 150.)

But whether the rate regulations actually adopted by the Insurance Commissioner, including the incorporated generic determinations, are necessary and proper for the implementation of Proposition 103 is scrutinized for arbitrariness and/or capriciousness. (E.g., *California Assn. of Psychology Providers v. Rank, supra,* 51 Cal.3d at pp. 11-12, 270 Cal.Rptr. 796, 793 P.2d 2; see *id.* at p. 11, fn. 5, 270 Cal.Rptr. 796, 793 P.2d 2 [noting that "Government Code section 11350, subdivision (b), . . . also permits a court to declare a regulation invalid if 'the agency's determination that the regulation is reasonably necessary to effectuate the purpose of the statute, court decision, or other provision of law which is being implemented, interpreted, or made specific by the regulation is not supported by substantial evidence[]' "].)

Lastly, in reviewing the 20th Century rate rollback order issued by the Insurance Commissioner, the superior court is required to weigh the evidence in accordance with its independent judgment and then to sustain the order if it finds adequate evidentiary support and to strike it down if it does not. Insurance Code section 1861.08, which was added by Proposition 103, provides for hearings by the commissioner on the rates of individual insurers. Insurance Code section 1861.09, which also was added by the initiative, provides for judical review of the commissioner's decisions relative thereto. It specifies that "[j]udicial review shall be in accordance with" Insurance Code section 1858.6, which antedates the initiative: "Any finding, determination, rule, ruling or order made by the commissioner" on rates "shall be subject to review by the courts of the State. . . . In such proceedings on review, the court is authorized and directed to exercise its independent judgment on the evidence and unless the weight of the evidence supports the findings, determination, rule, ruling or order of the commissioner, the same shall be

annulled. . . ."[9] In reviewing the superior court's findings, the appellate court considers whether they are supported by substantial evidence. (E.g., *Bixby v. Pierno* (1971) 4 Cal.3d 130, 143, fn. 10, 93 Cal.Rptr. 234, 481 P.2d 242.)

The insurers contend that the superior court erred by determining that the arbitrary-or-capricious standard of review, as opposed to the independent-judgment-on-the-evidence test, is applicable to the question whether the rate regulations actually adopted by the Insurance Commissioner, including the incorporated generic determinations, are necessary and proper for the implementation of Proposition 103.

We reject the claim. The arbitrary-or-capricious standard of review is the rule as to whether regulations are necessary and proper for the implementation of a statute. There is no reason to create an exception here. Our explanation follows.

As incorporated in Proposition 103 indirectly through Insurance Code section 1861.08 and directly through Insurance Code section 1861.09, Insurance Code section 1858.6 applies the independent-judgment-on-the-evidence standard of review to decisions by the Insurance Commissioner on the rates of individual insurers. The provision does not extend the test to the commissioner's adoption of rate regulations. That causes no surprise. Such authority as the commissioner may have under the initiative to promulgate regulations of this sort is implied and not express. We cannot find in the initiative, either in Insurance Code section 1861.09 or elsewhere, what the insurers purport to discern, i.e., an intent to require *all*

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[9] It should be noted in passing that Insurance Code section 1858.6 does not purport to authorize the superior court to independently review *a rate rollback order itself* and to substitute its own views in place of the Insurance Commissioner's if it disagrees, but only to independently review *the evidence underlying the order.*

determinations by the commissioner bearing on rates to be subject to the independent-judgment-on-the-evidence test.

Insofar as it may be said to operate outside Proposition 103, Insurance Code section 1858.6 functions similarly. That is to say, it applies the independent-judgment-on-the-evidence standard of review to various decisions by the Insurance Commissioner on the rates of individual insurers and related matters—specifically, "any rate charged, rating plan, rating system, or underwriting rule followed or adopted by [any] insurer or rating organization" (Ins. Code, § 1858, subd. (a)). But it does not extend the test to the commissioner's adoption of rate regulations. The fact that it contains the term "rule[s]," which is sometimes synonymous with regulations, and the terms "finding[s]" and determination[s]," which are always implicated in regulations, might be of consequence only if statutory construction indulged in hypertechnical parsing. It does not.

That Insurance Code section 1858.6 so functions is supported by its legislative history. It was added (Stats. 1947, ch. 805, § 1, p. 1906) and amended (Stats.1949, ch. 174, § 1, p. 406) as part of the former "open competition" system of regulation. That system did not provide for the adoption of rate regulations.

On the matter of legislative history, the insurers direct our attention to the McBride-Grunsky Insurance Regulatory Act of 1947 (hereafter the McBride-Grunsky Act), which established the "open competition" system of regulation and added Insurance Code section 1858.6. They also direct our attention to the source of the McBride-Grunsky Act, which was certain "model rate regulatory legislation recommended by the National Association of Insurance Commissioners. . . ." (Weinstock & Maloney, Historical Preface, History and Development of Insurance Law in Cal., 42 West's Ann.Ins. Code (1972 ed.) p.

LXVII.)[10] The model legislation embodied a kind of "prior aproval" system, under which the adoption of rate regulations would not be inappropriate. Departing there-

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[10] In *Karlin v. Zalta* (1984) 154 Cal.App.3d 953, 201 Cal.Rptr. 379, the court set out the background of the McBride-Grunsky Act.

"The United States Supreme Court in *Paul v. Virginia* (1868) 75 U.S. (8 Wall.) 168, 183, 19 L.Ed. 357 held that '[issuing] a policy of insurance is not a transaction of commerce' and that the conduct of the business of insurance does not constitute interstate commerce. This left the states free to regulate such business beyond the reach of federal law. [Citation.] Seventy-six years later, the question was reviewed in *U.S. v. Underwriters Assn.* (1944) 322 U.S. 533, 64 S.Ct. 1162, 88 L.Ed. 1440 (hereafter *South-Eastern*). To the consternation of the insurance industry, the court concluded that the insurance business was indeed engaged in interstate commerce subject to federal regulation under the commerce clause of the United States Constitution and that the Sherman Antitrust Act was applicable to its operation. Responding to the shock waves produced by this decision, Congress passed the McCarran-Ferguson Act (hereafter McCarran Act) in 1945 expressly declaring that it was in the public interest for the business of insurance to continue under state regulation and specifically exempted such business from the operation of federal antitrust laws to the extent that it was regulated by state law. A moratorium was provided until January 1, 1948, (and extended until June 30, 1948) to enable the states to exercise their regulatory authority." (*Karlin v. Zalta, supra,* 154 Cal.App.3d at pp. 966-967, 201 Cal.Rptr. 379, fn. omitted.)

"In 1907, California had adopted the Cartwright Act, an antitrust law which was [formerly believed to be] patterned after the Sherman Act and had been relatively dormant until about the time the McCarran Act was enacted. [Citation.] In 1946, two years after the landmark decision in the *South-Eastern* case, our Supreme Court rendered its decision in *Speegle v. Board of Fire Underwriters* (1946) 29 Cal.2d 34, 172 P.2d 867. . . . [It] held that [the Cartwright Act] was applicable to the business of insurance. . . ." (*Karlin v. Zalta, supra,* 154 Cal.App.3d at pp. 967-968, 201 Cal.Rptr. 379, fn. omitted.)

"In 1947, shortly prior to the expiration of the moratorium on the application of federal antitrust laws to the business of insurance in the absence of state regulation, California enacted" the McBride-Grunsky Act. (*Karlin v. Zalta, supra,* 154 Cal.App.3d at p. 968, 201 Cal.Rptr. 379.)

from, the McBride-Grunsky Act set up the "open competition" system, under which the opposite was true. (See Weinstock & Maloney, *supra,* p. LXVII [stating the McBride-Grunsky Act's "enforcement approach is the hindsight method and the principal instrumentality of such enforcement is the power of examination which the statute vests in the Commissioner"].) As the superior court correctly concluded, the McBride-Grunsky Act "clearly did not contemplate adoption of rate regulations, but was concerned with rating plans and underwriting rules. . . ." To identify the intent that underlies Insurance Code section 1858.6, the insurers seek to go behind the McBride-Grunsky Act to the model legislation. This they may not do. The intent that controls is that of the Legislature that enacted the McBride-Grunsky Act with its "open competition" system. It is not that of the National Association of Insurance Commissioners that recommended the model legislation with its kind of "prior approval" system.

The insurers may then be understood to argue that, for standard-of-review purposes, the rate regulations as to rollbacks should not be deemed regulations. The adoption of regulations by an administrative agency is an action that is, in nature, quasi-legislative rather than quasi-adjudicative. (See, e.g., Gov.Code, § 11346 [implying that the "adoption . . . of . . . regulations" is an "exercise of quasi-legislative power"]; see also *id.*, § 11342, subd. (b) [defining "regulation" in pertinent part as "every rule, regulation, order, or standard of general application"].) The sense of the argument seems to be that the regulations in question are quasi-adjudicative rather than quasi-legislative, or at least more the former than the latter.

As a general matter, an "administrative action is quasi-legislative" when the "administrative agency is creating a new rule for future application. . . ." (*Dominey v. Department of Personnel Administration* (1988) 205 Cal. App.3d 729, 737, fn. 4, 252 Cal.Rptr. 620; accord, *Strumsky v. San Diego County Employees Retirement*

Assn. (1974) 11 Cal.3d 28, 35 fn. 2, 112 Cal.Rptr. 805, 520 P.2d 29 [stating that, "[g]enerally speaking, a legislative action is the formulation of a rule to be applied to all future cases"]; *Wilson v. Hidden Valley Mun. Water Dist.* (1967) 256 Cal.App.2d 271, 280, 63 Cal.Rptr. 889 [to similar effect: "quasi-legislative action . . . 'prescribes what the law shall be in future cases arising under it' "].)

By contrast, an "administrative action is . . . quasi-adjudicative" when the "administrative agency . . . is applying an existing rule to existing facts." (*Dominey v. Department of Personnel Administration, supra,* 205 Cal. App.3d at p. 737, fn. 4, 252 Cal.Rptr. 620; accord, *Strumsky v. San Diego County Employees Retirement Assn., supra,* 11 Cal.3d at p. 35, fn. 2, 112 Cal.Rptr. 805, 520 P.2d 29 [stating that, "[g]enerally speaking, . . . an adjudicatory act involves the actual application of . . . a rule to a specific set of existing facts"]; *Wilson v. Hidden Valley Mun. Water Dist., supra,* 256 Cal.App.2d at pp. 279-280, 63 Cal.Rptr. 889 [to similar effect: "quasi-judicial . . . action . . . 'determines what the law is, and what the rights of parties are, with reference to transactions already had' "].)

The classification of administrative action as quasi-legislative or quasi-adjudicative "contemplates the function performed. . . ." (*Pitts v. Perluss* (1962) 58 Cal.2d 824, 834, 27 Cal.Rptr. 19, 377 P.2d 83.) And, we think, *only* the function performed.

Under these principles, we believe that, for standard-of-review purposes, the rate regulations as to rollbacks must surely be deemed regulations. They are quasi-legislative and not quasi-adjudicative.

As noted, the rate regulations as to rollbacks include: (1) regulations strictly so called, viz., rules generally applicable to all insurers formulated in quasi-legislative proceedings; and (2) regulations incorporating generic determinations, viz., findings relating to all or at least sev-

eral insurers made in consolidated hearings conducted in accordance with quasi-adjudicatory procedures and then adopted as regulations.

In whole and in part, the adoption of the rate regulations as to rollbacks constitutes the creation of "new rule[s] for future application. . . ." (*Dominey v. Department of Personnel Administration, supra,* 205 Cal.App.3d at p. 737, fn. 4, 252 Cal.Rptr. 620; accord, *Strumsky v. San Diego County Employees Retirement Assn., supra,* 11 Cal.3d at p. 35, fn. 2, 112 Cal.Rptr. 805, 520 P.2d 29; *Wilson v. Hidden Valley Mun. Water Dist., supra,* 256 Cal.App.2d at p. 280, 63 Cal.Rptr. 889.) It does not amount simply to the application of "existing rule[s] to existing facts." (*Dominey v. Department of Personnel Administration, supra,* 205 Cal.App.3d at p. 737, fn. 4, 252 Cal.Rptr. 620; accord, *Strumsky v. San Diego County Employees Retirement Assn., supra,* 11 Cal.3d at p. 35, fn. 2, 112 Cal.Rptr. 805, 520 P.2d 29; *Wilson v. Hidden Valley Mun. Water Dist., supra* 256 Cal.App.2d at pp. 279-280, 63 Cal.Rptr. 889.)[11]

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[11] In *Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. 938, the court opined, albeit in a context different from the present, that the rate regulations as to rollbacks are quasi-adjudicative and not quasi-legislative. (*Id.* at pp. 947, fn. 10, 956-958.) It misstepped.

In part, the *Fireman's Fund* court characterized the rate regulations as to rollbacks as quasi-adjudicative on the ground that they do not amount to "*new* rule[s] for future application" (*Dominey v. Department of Personnel Administration, supra,* 205 Cal.App.3d at p. 737, fn. 4, 252 Cal.Rptr. 620, italics added) because they implement *existing* law in the form of Proposition 103 as construed in *Calfarm.* (See *Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at p. 957 ["The determination of the insurers' rollback obligations is not 'the making of a rule for the future.' In *Calfarm,* the California Supreme Court delegated to the Commissioner the task of determining the insurers' rollback obligations under *existing* law; that is, Prop[osition] 103, as modified by the *Calfarm* decision." (Italics in original.)] Under such reasoning, *all* regulations would be deemed quasi-adjudicative since all are supported by existing law, at least to some extent. That cannot be. To our mind, the regulations in question are indeed "new rules." They

Our conclusion that the rate regulations as to rollbacks are quasi-legislative is unremarkable. When performed by an administrative agency, ratemaking has uniformly been considered a quasi-legislative action. (See, e.g., *California Hotel & Motel Assn. v. Industrial Welfare Com.* (1979) 25 Cal.3d 200, 211, 157 Cal.Rptr. 840, 599 P.2d 31 [implying that an administrative agency "exercise[s] a legislative function" when it "adopt[s] orders,

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may not change the general lines of the initiative. But they do fill in its gaps.

In part, the *Fireman's Fund* court characterized the rate regulations as to rollbacks as quasi-adjudicative on the ground that the Insurance Commissioner's "ultimate job is to determine how much each insurer must refund. . . ." (*Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at p. 957.) That may be. But it is not determinative. In *Consumers Lobby Against Monopolies v. Public Utilities Com.* (1979) 25 Cal.3d 891, 160 Cal.Rptr. 124, 603 P.2d 41, we held that the "fixing of a rate and the reducing of that rate are prospective in application and quasi-legislative in character." (*Id.* at p. 909, 160 Cal.Rptr. 124, 603 P.2d 41 (lead opn. by Mosk, J.); accord, *id.* at p. 916, 160 Cal.Rptr. 124, 603 P.2d 41 (conc. & dis. opn. of Richardson, J.).) We further held that the ordering of a refund of rates is "akin to a reduction in rates," when the rates in question were charged "pending a determination of [their] legality. . . ." (*Id.* at p. 910, 160 Cal.Rptr. 124, 603 P.2d 41 (lead opn. by Mosk, J.); accord, *id.* at p. 916, 160 Cal. Rptr. 124, 603 P.2d 41 (conc. & dis. opn. of Richardson, J.).) Under these holdings, the rate regulations as to rollbacks are indeed quasi-legislative.

The *Fireman's Fund* court should not have misstepped. It recognized that the rate regulations "as to future rates . . . are quasi-legislative." (*Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at pp. 956-957.) It should have recognized that the rate regulations "[a]s to rollback obligations" are the same. (*Id.* at p. 956.) In both the former and the latter applications, the rate regulations are similar in form and substance. That in the latter application they happen to be brought to bear after the rates in question were charged "pending a determination of [their] legality" (*Consumers Lobby Against Monopolies v. Public Utilities Com., supra,* 25 Cal.3d at p. 910, 160 Cal.Rptr. 124, 603 P.2d 41 (lead opn. by Mosk, J.)) does not render them quasi-adjudicative instead of quasi-legislative.

rules, regulations, and policies to fix" rates].) That is because "ratemaking is an essentially legislative act. . . ." (*New Orleans Pub. Serv., Inc. v. New Orleans* (1989) 491 U.S. 350, 371, 109 S.Ct. 2506, 2519-20, 105 L.Ed. 2d 298.)

That is self-evidently true so far as the creation of general rules is concerned. (See, e.g., *California Hotel & Motel Assn. v. Industrial Welfare Com., supra,* 25 Cal. 3d at p. 211, 157 Cal.Rptr. 840, 599 P.2d 31 [implying that an administrative agency "exercise[s] a legislative function" when it "adopt[s] . . . rules, regulations, and policies to fix" rates].)

But it is true as well so far as the application of such rules in individual cases is involved. (See, e.g., *Prentis v. Atlantic Coast Line* (1908) 211 U.S. 210, 226, 29 S.Ct. 67, 69, 53 L.Ed. 150 [stating that the "establishment of a rate . . . is an act legislative not judicial in kind"]; *Wood v. Public Utilities Commission* (1971) 4 Cal.3d 288, 292, 93 Cal.Rptr. 455, 481 P.2d 823 [stating that "in fixing rates, a regulatory commission exercises legislative functions . . . and does not, in so doing, adjudicate vested interests or render quasi-judicial decisions"]. That Insurance Code section 1861.08, which provides for hearings by the Insurance Commissioner on the rates of individual insurers, requires the use of quasi-adjudicatory procedures (Ins. Code, § 1861.08 ["Hearings shall be conducted pursuant to Sections 11500 through 11528 of the Government Code," which relate to administrative adjudication]) is not inconsistent. The "presence of certain elements usually characteristic of the judicial process" does not "mean that the" commissioner's "action" is quasi-adjudicative. (*Wilson v. Hidden Valley Mun. Water Dist., supra,* 256 Cal.App2d at p. 279, 63 Cal.Rptr. 889; accord, *City of Santa Cruz v. Local Agency Formation Comm.* (1978) 76 Cal.App.3d 381, 388, 142 Cal.Rptr. 873; see *Pacifica Corp. v. City of Camarillo* (1983) 149 Cal.App.3d 168, 176, 196 Cal.Rptr. 670; *Patterson v.*

Central Coast Regional Com. (1976) 58 Cal.App.3d 833, 841, 130 Cal.Rptr. 169.)

The insurers argue to the effect that ratemaking is ultimately a judicial function, at least when the question of confiscation is present. Of course, confiscation is always implicated, at least potentially, whenever rates are set. In spite of that fact, it is established beyond peradventure that ratemaking is *not* a judicial function. (E.g., *Prentis v. Atlantic Coast Line, supra,* 211 U.S. at p. 226, 29 S.Ct. at p. 69.) The analysis the insurers employ is inapt. That the determination of what compensation is just after a taking has been effected belongs to the courts says nothing about ratemaking, which seeks among other goals to set prices to avoid effecting a taking in the first place. Obviously, ratemaking is subject to judicial review. But that is another matter. Further, the approach the insurers take is no longer current. To a greater or lesser degree, their discussion is animated by *Lochner v. New York* (1905) 198 U.S. 45, 25 S.Ct. 539, 49 L.Ed. 937, and its ancestors and progeny. That line, however, is long since dead. Contrary to what appears to be their belief, "[t]he day is gone when" courts could "use[] the Due Process Clause of the Fourteenth Amendment"—or any other provision of the United States Constitution—"to strike down state laws, regulatory of business and industrial conditions, because they may be unwise, improvident, or out of harmony with a particular school of thought." (*Williamson v. Lee Optical Co.* (1955) 348 U.S. 483, 488, 75 S.Ct. 461, 464, 99 L.Ed. 563.)

To conclude that the rate regulations as to rollbacks are quasi-legislative is not to deny that their adoption involved the "finding" of "facts," both in the formulation of the regulations strictly so called and perhaps especially in the making of the generic determinations.

But the "finding" of such "facts" does indeed belong to the quasi-legislative function. That is the case when, as here, the administrative agency's task "was to receive and

consider economic and social data, as well as opinion and argument, covering large numbers of people and wide sectors of the economy; to select a series of positions aimed at the statutory objectives but shaped by discretion and policy; finally, to express its selection in rules regulating the future conduct of relatively broad classes of persons." (*Rivera v. Division of Industrial Welfare* (1968) 265 Cal.App.2d 576, 586, 71 Cal.Rptr. 739.)[12]

Similarly, to conclude that the rate regulations as to rollbacks are quasi-legislative is not to deny that their adoption entailed the use of quasi-adjudicatory procedures in the making of the generic determinations.

But the fact that regulations are formulated under quasi-adjudicative procedures does not undermine their quasi-legislative nature. As stated, the "presence of certain elements usually characteristic of the judicial process" does not "mean that the" Insurance Commissioner's "action" is quasi-adjudicative. (*Wilson v. Hidden Valley Mun. Water Dist., supra,* 256 Cal.App.2d at p. 279, 63 Cal.Rptr. 889.) "[A]dministrators exercising quasi-legislative powers commonly resort to the [judicial] hearing procedure to uncover, at least in part, the facts necessary to arrive at a sound and fair legislative decision. . . .

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[12] Not only does the "finding" of such "facts" belong to the quasi-legislative function. The "facts" "found" must themselves be viewed as quasi-legislative in nature. All are informed with legal, policy, and technical considerations, including those implicated in the generic determinations concerning the efficiency standards, rate of return, leverage factor, etc. Consequently, none is similar to the sort of "historical or physical facts" (*Crocker National Bank v. City and County of San Francisco, supra,* 49 Cal.3d at p. 888, 264 Cal.Rptr. 139, 782 P.2d 278) typically found in the course of administrative adjudication. Any similarity, however, would not defeat their quasi-legislative nature. (See *Prentis v. Atlantic Coast Line, supra,* 211 U.S. at p. 227, 29 S.Ct. at p. 70 [implying that the fact that "questions considered [in the legislative process] might be the same that would arise in the trial of a case" does not transform a legislative act into a judicial act].)

Hence the presence of certain characteristics common to the judicial process does not change the basically quasi-legislative nature of . . . proceedings" of that type. (*Ibid.*, citations and fn. omitted; accord, *City of Santa Cruz v. Local Agency Formation Com., supra*, 76 Cal.App.3d at p. 388, 142 Cal.Rptr. 873.) True, "to hold hearings, take evidence and make findings creates characteristics shared by adjudicatory proceedings. . . ." (*Rivera v. Division of Industrial Welfare, supra*, 265 Cal.App.2d at p. 587, 71 Cal.Rptr. 739.) Nonetheless, it "does not stamp the function with an adjudicative character." (*Ibid.*)[13]

C. *The General Validity of the Rate Regulations as to Rollbacks*

The superior court determined that the rate regulations as to rollbacks are not invalid on their face as statutorily unsupported.

In our review, we must briefly address a threshold issue.

The insurers contend in this proceeding as they contended in *Calfarm* that Propostion 103's rate rollback re-

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[13] The insurers may be understood to argue that the independent-judgment-on-the-evidence standard is applicable to the question whether the rate regulations actually adopted by the Insurance Commissioner, including the incorporated generic determinations, are necessary and proper for the implementation of Proposition 103, on the ground that the regulations in question implicate the United States and/or California Constitutions. An argument of this sort would allow the rule of arbitrary-or-capricious review to be swallowed up by a purported "exception." That is because *all* regulations involve the federal and/or state charters, at least to some degree. We are not persuaded that we must, or even should, pursue such a course. *Bixby v. Pierno, supra*, 4 Cal.3d 130, 93 Cal.Rptr. 234, 481 P.2d 242, which is relied on by the insurers together with similar decisions, is not to the contrary. Its reasoning applies to actions that are quasi-adjudicative and not to those that are quasi-legislative. (See *Strumsky v. San Diego County Employees Retirement Assn., supra*, 11 Cal.3d at pp. 34-35 & fn. 2, 112 Cal.Rptr. 805, 520 P.2d 29.)

quirement provision, viz., Insurance Code section 1861.01, subdivision (a), which sets the maximum rate for the rollback year at 80 percent of the 1987 rate, is facially invalid as confiscatory. Their arguments were weighed and found wanting in *Calfarm*. There is simply no reason to revisit the issue here.

Without question, the rate regulations as to rollbacks are not invalid as statutorily unsupported *insofar as they relate to procedure*. In *Calfarm*, we determined the Insurance Commissioner's authority in this sphere. There, we held that the commissioner "has broad discretion to adopt rules and regulations as necessary to promote the public welfare" in this regard. (*Calfarm Ins. Co. v. Deukmejian, supra*, 48 Cal.3d at p. 824, 258 Cal.Rptr. 161, 771 P.2d 1247.)

Neither are the rate regulations as to rollbacks invalid as statutorily unsupported *insofar as they relate to substance*. In *Calfarm*, we did not determine the Insurance Commissioner's authority in this sphere. We do so here, In *Calfarm*, we held that if an insurer "believes the rates set by [Insurance Code] section 1861.01, subdivision (a), are confiscatory" and "file[s] an application . . . for approval of a higher rate," the commissioner must determine whether "the initiative's rate, or some other rate less than the insurer charged, is fair and reasonable. . . ." (*Calfarm Ins. Co. v. Deukmejian, supra*, 48 Cal.3d at p. 825, 258 Cal.Rptr. 161, 771 P.2d 1247.) To do so, the commissioner must establish rules to resolve various interstitial legal, policy, and technical issues. An administrative official may frame rules deliberately in quasi-legislative proceedings to adopt regulations. Or he may develop rules ad hoc in the course of quasi-adjudicatory review. We believe that Proposition 103 authorizes the commissioner to take the former path. As we made plain in *Calfarm*, the commissioner "may exercise such . . . powers . . . as may fairly be implied" from the initiative. (*Id.*, at p. 824, 258 Cal. Rptr. 161, 771 P.2d 1247,

internal quotation marks and italics omitted.) In our view, the adoption of substantive regulations is one of these powers. As construed in *Calfarm*, Proposition 103 effectively requires the commissioner to establish rules. It implicitly empowers him to proceed by regulation. Certainly, it does not bar him from doing so. Included, of course, are regulations strictly so called, i.e., rules generally applicable to all insurers formulated by the commissioner in quasi-legislative proceedings. Included as well are regulations incorporating generic determinations, i.e., findings relating to all or at least several insurers made by the commissioner in consolidated hearings conducted in accordance with quasi-adjudicatory procedures and then adopted by him as regulations. This follows from our implication in *Calfarm* that the commissioner could "consolidat[e] cases" and generally "tak[e] whatever steps are necessary to reduce the job to manageable size." (*Ibid.*) There is, without doubt, nothing novel in the adoption of regulations incorporating generic determinations. (Cf., e.g., Cal. Code Regs., tit. 22, § 51536 et seq. [setting rates for reimbursement for hospital inpatient services provided to Medi-Cal program beneficiaries]; see especially *id.* § 51536, subd (g)(3) [defining a "market basket classification"].)

The insurers argue that the rate regulations as to rollbacks are indeed invalid as statutorily unsupported insofar as they relate to substance. They do not persuade. For the reasons stated, we believe that, as construed in *Calfarm*, Proposition 103 does indeed authorize the Insurance Commissioner to adopt substantive rate regulations to implement the rate rollback requirement provision. The insurers' assertion—viz., that in Insurance Code section 1861.08, the initiative requires the commissioner to conduct hearings on the rates of individual insurers by means of quasi-adjudicatory procedures—is correct. The inference that they attempt to draw—viz., that the commissioner cannot do anything else relative to rates by any

other means—is unsound. We cannot find in the initiative, either in Insurance Code section 1861.08 or elsewhere, what the insurers purport to discern, i.e., an intent to require *all* determinations by the commissioner bearing on rates to be made in quasi-adjudicatory proceedings on the rates of individual insurers.

The insurers then argue that the rate regulations as to rollbacks are invalid as statutorily unsupported insofar as they relate to substance because they are impermissibly "retroactive."

It is unclear whether and to what extent the superior court made any determination in accordance with the insurers' argument. Insofar as it did, it erred.

The rate regulations as to rollbacks may properly be considered prospective. The "fixing of a rate and the reducing of that rate are prospective in application. . . ." (*Consumers Lobby Against Monopolies v. Public Utilities Com., supra,* 25 Cal.3d at p. 909, 160 Cal.Rptr. 124, 603 P.2d 41 (lead opn. by Mosk, J.); accord, *id.* at p. 916, 160 Cal.Rptr. 124, 603 P.2d 41 (conc. & dis. opn. of Richardson, J.). The ordering of a refund of rates is "akin to a reduction in rates," when, as here, the rates in question were charged "pending a determination of [their] legality. . . ." (*Id.* at p. 910, 160 Cal.Rptr. 124, 603 P.2d 41 (lead opn. by Mosk, J.); accord, *id.* at p. 916, 160 Cal.Rptr. 124, 603 P.2d 41 (conc. & dis. opn. of Richardson, J.).) It follows that the ordering of a refund of rates is itself prospective. Since the regulations in question serve such a refund, they may soundly be viewed to share its character.

But even if the rate regulations as to rollbacks might be deemed "retroactive," they cannot be deemed impermissibly so. " 'Primary' retroactivity"—to coin a phrase —obtains when regulations "alter[] the *past* legal consequences of past actions." (*American Min. Congress v. U.S.E.P.A.* (9th Cir.1992) 965 F.2d 759, 769, italics in

original; see *National Medical Enterprises, Inc. v. Sullivan* (9th Cir.1992) 957 F.2d 664, 671.) That is not present here. " 'Secondary' retroactivity" occurs when regulations "affect[] the *future* legal consequences of past transactions. . . ." (*National Medical Enterprises, Inc. v. Sullivan, supra,* 957 F.2d at p. 671, italics in original.) That is indeed present. "[B]ut such ' "secondary" retroactivity' is an entirely lawful consequence of much agency rulemaking and does not by itself render a rule invalid." (*Ibid.*) That it is an "*entirely* lawful consequence" means just that: it does not itself offend any law, including the United States and California Constitutions and their respective due process clauses.

In making their argument for the impermissible "retroactivity" of the rate regulations as to rollbacks, the insurers rely on *Bowen v. Georgetown University Hospital* (1988) 488 U.S. 204, 109 S.Ct. 468, 102 L.Ed.2d 493. That decision is distinguishable, concerning as it does certain Medicare cost-limit regulations "altering the *past* legal consequences of past actions" under predecessor regulations. (*Id.* at p. 219, 109 S.Ct. at p. 477, italics in original (conc. opn. of Scalia, J.).)

We may observe in passing that the rate regulations as to rollbacks were not adopted until after the rollback year. That fact cannot itself render them impermissibly "retroactive." For about a year prior to the approval of Proposition 103, insurers were on actual notice of the rate rollback requirement provision itself.[14]

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[14] The insurers appear to argue that the rate regulations as to rollbacks are invalid as *constitutionally prohibited* insofar as they relate to substance. We find no such bar in the United States or California Constitution. To the extent that this point may depend on the assertion that rate-making is ultimately a judicial function, at least when the question of confiscation is persent, it must be rejected. (See pt. III.B., *ante.*)

D. *The Validity of the Rate Regulations as to Rollbacks With Respect to the Ratemaking Formula.*

The superior court determined that the rate regulations as to rollbacks are invalid on their face with respect to the ratemaking formula.

Before we proceed further, we would do well to make two observations.

One is relatively narrow, and concerns matters of accounting. In his separate opinion in the landmark decision of *Power Comm'n v. Hope Gas Co.* (1944) (320 U.S. 591, 64 S.Ct. 281, 88 L.Ed.2d 333 (hereafter sometimes *Hope*), Justice Jackson commented: "To make a fetish of mere accounting is to shield from examination the deeper causes, forces, movements, and conditions which should govern rates. . . . [B]ookeeping is hardly an exact science. As a representation of the condition and trend of a business, it uses symbols of certainty to express values that actually are in constant flux. It may be said that in commercial or investment banking or any business extending credit success depends on knowing what not to believe in accounting. Few concerns go into bankruptcy or reorganization whose books do not show them solvent and often even profitable. . . . However, our quest for certitude is so ardent that we pay an irrational reverence to a technique that uses symbols of certainty, even though experience again and again warns us that they are delusive." (*Id.* at pp. 643-644, fn. 40, 64 S.Ct. at pp. 307-308, fn. 40 (opn. of Jackson, J.).) We shall pay no such reverence.

The other observation is relatively broad, and concerns matters of policy.

Under Proposition 103 as construed in *Calfarm,* insurers were allowed to file "rollback-exemption" applications. An insurer that filed such an application should not be "penalized" for having charged, pending approval and subject to refund, a rate for the rollback year higher

than the maximum rate of 80 percent of the 1987 rate. That appears obvious. But neither should it be "rewarded" for having done so. That seems less obvious. It is nonetheless true. As stated, the ratemaking formula is designed to yield a premium that the insurer should receive from its insureds in order to earn a sum amounting to (1) the reasonable cost of providing insurance and (2) the capital used and useful for providing insurance multiplied by a fair rate of return. By charging a higher rate for the rollback year, the insurer "increased" its cost of providing insurance, for example, by incurring liability for added commissions, state premium tax, and federal income tax on the added premiums. It also "increased" its capital multiplied by a rate of return, specifically by "increasing" its capital base, for example, by triggering added surplus to back up the added premiums. Such "increases" would inflate the premium yielded by the ratemaking formula. They cannot be recognized. If they were, a higher rate would be self-justifying: the *fact* that the insurer charged such a rate would grant it a *right* to have done so. That cannot be. There is surely no unfairness in nonrecognition. Insurers were on notice that, in charging a higher rate, they were proceeding at their own risk: they had to establish their entitlement to that rate; it did not carry its entitlement within itself.

For illustration, let us consider the following example. Insurer *A* and Insurer *B* are similarly situated. The 1987 rate for each was $1,000. A maximum rate for the rollback year of 80 percent of the 1987 rate, viz., $800, is nonconfiscatory and otherwise lawful for each under the rate rollback requirement provision of Proposition 103. Not disputing the matter, Insurer *A* reduces its rate to $800. Filing a "rollback-exemption application," Insurer *B* takes the opposite path and increases its rate to $1,200. In so doing, Insurer *B* "increases" its cost of providing insurance by incurring liability for: (1) added commissions at, say, the customary rate of 20 percent on the added premium of $400, equaling $80; (2) added state

premium tax at, say, the established rate of 2.37 percent on the added premium of $400, equaling $9.48; and (3) added federal income tax at, say, the marginal rate of 34 percent on the added premium of $400, equaling $136—to the total of $225.48. Insurer *B* also "increases" its capital multiplied by a rate of return. It does so, specifically, by "increasing" its capital base, by triggering added surplus at, say, the simplest leverage ratio of 1:1, to back up the added premium of $400, in the amount of $400. Let us assume a rate of return of 10 percent. Insurer *B* thereby "increases" its capital multiplied by a rate of return to the total of $40. Insurer *B*'s "increases," if they were recognized, would inflate the premium yielded by the ratemaking formula by $265.48—$225.48 for the "cost" component *plus* $40 for the "capital" component. In other words, Insurer *B*'s "increases," if they were recognized, would "increase" its maximum rate for the rollback year from $800 to $1,065.48. They cannot be recognized. Insurer *B* has charged $400 too much: it must refund that amount. It should suffer no "penalty" for its overcharge. That means that it must refund *only* $400 (exclusive of interest). But neither should it be given a "reward" for its overcharge. That means that it must indeed refund *$400* (exclusive of interest). Otherwise, inequity would result. There would be unfairness between Insurer *A* and Insurer *B*, which would be treated dissimilarly as subjects of the rate rollback requirement provision, Insurer *A* with a maximum rate of $800 and Insurer *B* with a maximum rate of $1,065.48. There would also be unfairness between Insurer *B* and its insureds; the former overcharging the latter and the latter overpaying the former in the amount of $265.48. Lastly, there would be unfairness between the insureds of Insurer *A* and the insureds of Insurer *B*, who would be treated dissimilarly as beneficiaries of the rate rollback requirement provision, the former receiving the mandated decrease in rates equaling $200 and the latter receiving a prohibited differential in rates equaling $265.48.

The first of two major bases on which the superior court rested its determination that the rate regulations as to rollbacks are invalid with respect to the ratemaking formula was its conclusion to the following effect: Proposition 103 does not authorize the Insurance Commissioner to adopt any ratemaking formula whatsoever to implement the rate rollback requirement provision; it does not permit him to set rates himself; as a general matter, it allows him merely to approve or disapprove rates proposed by individual insurers, applying (as relevant here) the "excessive"/"inadequate" standard; as to rollbacks specifically, it requires him to approve any proposed rate that is minimally above the "inadequate" and to disapprove any other, even if such other rate falls at some other point below the "excessive."

The superior court's conclusion in this regard is substantially erroneous.

At the outset, we must make the following observation. Through the ratemaking formula, the Insurance Commissioner does not himself "set" rates for insurers. Rather, he simply determines the rate or rates that the individual insurer may itself set within the constraints of Proposition 103 as construed in *Calfarm*. For the "prior approval" system, the ratemaking formula is used to fix for the individual insurer the range of rates within the bounds of the "excessive" and the "inadequate." For the rate rollback, with which we are here concerned, it is used to fix for the individual insurer its maximum rate under Proposition 103 as construed in *Calfarm*—i.e., the rate that is 80 percent of the 1987 rate *or* such rate greater than 80 percent of the 1987 rate as is minimally nonconfiscatory.

In *Calfarm*, we stated that under Proposition 103 "any insurer who believes the rates set by [Insurance Code] section 1861.01, subdivision (a), are confiscatory may file an application with the Insurance Commissioner for approval of a higher rate. If that application is filed be-

fore November 8, 1989, the insurer may immediately begin charging that higher rate pending approval from the commissioner. After that date insurance rates subject to Proposition 103 must be approved by the commissioner prior to their use, but . . . the commissioner can approve an interim rate pending [his or] her final decision. *If the commissioner finds the initiative's rate, or some other rate less than the insurer charged, is fair and reasonable, the insurer must refund excess premiums collected with interest. No insurer, however, will be compelled to charge the rates set by the initiative unless it either acquiesces in that rate or is unable to prove that a higher rate is constitutionally required.*" (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 825, 258 Cal.Rptr. 161, 771 P.2d 1247, italics added and fn. omitted.)

As construed in *Calfarm,* Proposition 103 does in fact authorize the Insurance Commissioner to adopt a rate-making formula to implement the rate rollback requirement provision—specifically, to determine whether, for an individual insurer, a maximum rate for the rollback year higher than 80 percent of the 1987 rate is required to avoid confiscation and, if so, what such higher maximum rate is.

By its very terms, Proposition 103 sets a maximum rate for the rollback year.

As construed in *Calfarm,* Proposition 103 requires the Insurance Commissioner, if he finds the initiative's maximum rate confiscatory for an individual insurer, to determine a higher maximum rate that is minimally nonconfiscatory. To do so, he must, as it were, "make" a rate. And to do that, we believe, he may proceed by formula rather than case by case. Indeed, it is arguable that he *should* proceed in that fashion. One of the purposes of Proposition 103 is "to protect consumers from arbitrary insurance rates. . . ." (Prop. 103, Gen. Elec. Nov. 8, 1988) § 2, reprinted in Ballot Pamp., Proposed Stats. and Amends. to Cal. Const. with arguments to voters, Gen.

Elec. (Nov. 8, 1988) p. 99.) Formulaic ratemaking furthers that goal. Case-by-case ratemaking does the opposite. (Cf. 1 Davis & Pierce, Administrative Law Treatise (3d ed. 1994) § 6.7, p. 261 ["Over the years, commentators, judges, and Justices have shown near unanimity in extolling the virtues of the rulemaking process over the process of making 'rules' through case-by-case adjudication."].) There is, without doubt, nothing novel in the use of formulas of all sorts. (Cf., e.g., Cal.Code Regs., tit. 22, § 51536 et seq. [setting rates for reimbursement for hospital inpatient services provided to Medi-Cal program beneficiaries]; see especially *id.*, § 51549 [establishing a "reimbursement formula"].)

It goes without saying that when the Insurance Commissioner determines that a maximum rate higher than Proposition 103's is minimally nonconfiscatory for an individual insurer, he does not "set" a rate. This point bears emphasis because it was inexplicably ignored by the superior court: *For the rollback year, strictly speaking, each and every insurer set its own rates; the Insurance Commissioner set not a one.*

In concluding to the contrary, the superior court read Proposition 103 as construed in *Calfarm* to preclude the Insurance Commissioner from setting rates himself and to allow him merely to approve or disapprove rates proposed by individual insurers, applying (as relevant here) the "excessive"/"inadequate" standard. This was a misreading.

Proposition 103 as construed in *Calfarm* requires the Insurance Commissioner, if he finds the initiative's maximum rate confiscatory for an individual insurer, to determine a higher maximum rate that is minimally nonconfiscatory. He does not "set" a rate in so doing.

Further, it is not the case that Proposition 103 as construed in *Calfarm* allows the Insurance Commissioner

merely to approve or disapprove insurer-proposed rates under the "excessive"/"inadequate" standard. That standard belongs to the "prior approval" system, which governs rates from November 8, 1989, into the future. It does not extend to the rate rollback, which obtained for rates from November 8, 1988, through November 7, 1989. Even if it did, it would matter not. The superior court effectively recognized that an individual insurer's maximum rate for the rollback year, if above 80 percent of the 1987 rate, must be that which is minimally nonconfiscatory: Under the rate rollback requirement provision—to use the terms appearing in Insurance Code section 1861.05, subdivision (a)—a rate is "inadequate" if confiscatory and "excessive" if more than minimally nonconfiscatory and above 80 percent of the 1987 rate. It would exalt form over substance, and entail the needless expense of time and money, to hold that the commissioner could only disapprove a perhaps numberless succession of insurer-proposed rates fixed above the minimally nonconfiscatory until finally he was required to approve such a rate that happened to hit the proper level—instead of simply determining the minimally nonconfiscatory rate at the outset. Proposition 103 as construed in *Calfarm* does not require the commissioner to take a passive role when an active one is not barred.[15]

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[15] Cf. *Trans Alaska Pipeline Rate Cases* (1978) 436 U.S. 631, 653, 98 S.Ct. 2053, 2066, 56 L.Ed.2d 591 ("Petitioners do not apparently disagree that the [Interstate Commerce] Commission can suspend a tariff because it falls on the wrong side of the line of reasonableness, but they would prevent the Commission in suspending a tariff from stating, as it did here, where the tentative dividing line lies. . . . But this is untenable: No principle of law requires the Commission to engage in a pointless charade in which [regulated firms] desiring to exercise their . . . rights [under the Interstate Commerce Act] are required to submit and resubmit tariffs until one finally goes below an undisclosed maximum point of reasonableness and is allowed to take effect. The administrative process, after all, is not modeled on 'The Price is Right.' What the Commission did here, therefore, far from being

In supporting the superior court's conclusion to the effect that Proposition 103 does not authorize the Insurance Commissioner to adopt any ratemaking formula whatesover to implement the rate rollback requirement provision, the insurers take the same fatal misstep. That is to say, they misread Proposition 103 as construed in *Calfarm*. Their misreading, however, appears even more profound. They would apparently abrogate the rate rollback requirement provision in its entirely by requiring the commissioner to proceed as under the "prior approval" system, i.e., to approve *any* proposed rate that is below the "excessive" and above the "inadequate." The commissioner may not do so. As stated, under the rate rollback requirement provision—to use the terms appearing in Insurance Code section 1861.05, subdivision (a)—a rate is "inadequate" if confiscatory and "excessive" if more than minimally nonconfiscatory and above 80 percent of the 1987 rate. At the heart of the insurers' argument is an assertion to the effect that *Calfarm* invalidated the rate rollback requirement provision and substituted in its place the substantive standard of the "prior approval" system. The assertion is unsupported. *Calfarm* invalidated the procedural mechanism for relief from the rate rollback requirement provision *and not* the rate rollback requirement provision itself. It substituted the procedural mechanism for the "prior approval" system *and not* the substantive standard of the "prior approval" system.

The second of the two major bases on which the superior court rested its determination that the rate regula-

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condemnable, is an intelligible and practical exercise of its suspension power. . . .")

It may be noted in passing that former section 1850 of the Insurance Code effectively denied the Insurance Commissioner the "power to fix and determine" rates. (Stats.1947, ch. 805, § 1, p. 1896.) That provision, however, was repealed by Proposition 103. (Prop. 103, Gen. Elec. (Nov. 8, 1988), 7, reprinted in Ballot Pamp., Proposed Stats. and Amends. to Cal. Const. with arguments to voters, Gen. Elec. (Nov. 8, 1988) p. 141.)

tions as to rollbacks are invalid with respect to the ratemaking formula was its conclusion to the following effect: Proposition 103 does not authorize the Insurance Commissioner to adopt the ratemaking formula in question to implement the rate rollback requirement provision; that formula is "recursive"; "unique" and without "precedent" among "similar statutes containing the widely used" "excessive"/"inadequate" standard; and internally inconsistent: through operation of the efficiency standards, the variable expense factor, and the leverage factor, it precludes a return covering the insurer's cost of service plus 10 percent of its capital base—a 10 percent rate of return on the capital base being defined as the lower boundary of the range of reasonable rates of return; through such preclusion, the formula is also confiscatory; confiscation does not require "deep financial hardship" within the meaning of *Jersey Central.*

In this regard too, the superior court's conclusion is substantially erroneous.

To be sure, the ratemaking formula is indeed "recursive." But contrary to the superior court's evident belief and the insurers' vigorously urged position, that is no vice. The adjective is not pejorative. It is merely descriptive. Simply put, it means in this context that the value solved for figures in the solution itself. For example, an insurer desires to determine the rate it must charge its insureds to net $100 after paying a 20 percent commission to its agents. It uses the following "recursive" formula, in which "r" refers to the rate to be charged: $r = \$100 + 0.2r$; $r - 0.2r = \$100$; $0.8r = \$100$; $r = \$125$. In and of itself, "recursiveness" is not objectionable. To the extent that the complaint goes beyond "recursiveness" to mere complexity, it fails. Although complicated, the ratemaking formula is not unduly so. (Cf., e.g., Cal.Code Regs., tit. 22, § 51536 et seq. [setting rates for reimbursement for hospital inpatient services provided to Medi-Cal program beneficiaries]; see especially *id.*, § 51549 [establishing a "reimbursement formula"].)

Similarly, the ratemaking formula is apparently "unique" and without "precedent" among "similar statutes containing the widely used" "excessive"/"inadequate" standard. But again contrary to the superior court's evident belief and the insurers' vigorously urged position, that is no vice. The reason is short and simple: So far as the ratemaking formula functions in the rate rollback, the temporary regulatory regime that operated from November 8, 1988, through November 7, 1989, it has nothing to do with the "prior approval" system, the permanent regulatory regime that obtains from November 8, 1989, into the future. That the two regimes are distinct is apparent in Proposition 103. It remains such in our construction of the initiative in *Calfarm*.

In any event; we must observe that the "excessive"/"inadequate" standard as defined in Proposition 103 is itself apparently "unique" and without "precedent" among "similar statutes. . . ." In subdivision (a) of Insurance Code section 1861.05, it shows itself to be distinguishable from the others: "In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company's investment income." The insurers direct our attention to what purports to be a campaign statement made prior to the November 8, 1988, General Election by Voter Revolt, the proponent of Proposition 103, to the effect that the "prior approval" system in the initiative is "[b]ased on [a] tested system in effect in 19 states." The statement says only that the initiative's "prior approval" system is *based on* similar systems. It does not say that it is identical to any one. The insurers argue in substance that the "excessive"/"inadequate" standard as defined in the initiative should be interpreted in accordance with the insurance industry's or the actuarial profession's understanding of its operative terms. We believe that subdivision (a) of Insurance Code section 1861.05, as quoted above, stands in the way.

Further, the ratemaking formula is not internally inconsistent. Contrary to the superior court's evident assumption, the ratemaking formula does not purport to guarantee the individual insurer a rate covering its cost of service plus 10 percent of its capital base independent of the various adjustments, exclusions, etc., incorporated therein.

We do not think it improper—constitutionally or otherwise—for the rate regulations as to rollbacks to recognize as the insurer's cost of service only the *reasonable* cost of providing insurance. It is not objectionable that the ratemaking formula's efficiency standards operate to define the reasonable cost of providing insurance after subjecting the insurer's "expenses . . . to downward normative pressure." (*Massachusetts Auto. Rating & Accident Prevention Bureau v. Commissioner of Ins.* (1980) 381 Mass. 592, 602, 411 N.E.2d 762.) The insurers charge that such devices are unprecedented outside the monopoly or public utility setting. That does not appear to be the case. (See *id.* at pp. 602-603, 411 N.E.2d 762.) It is also not objectionable that the ratemaking formula's variable expense factor excludes from the reasonable cost of providing insurance such commissions and state premium taxes as would have been avoided had the insurer charged a rate for the rollback year no higher than the maximum rate set by Proposition 103 as construed in *Calfarm*—i.e., the rate that is 80 percent of the 1987 rate *or* such rate greater than 80 percent of the 1987 rate as is minimally nonconfiscatory. "[I]t surely cannot be reasonable for an investor to assume that each and every expenditure . . . will be allowed by regulatory authorities." (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at p. 1193 (conc. opn. of Starr, J.).)

Neither do we think it improper for the rate regulations as to rollbacks to recognize as the insurer's capital base only the capital used and useful for providing insurance. (See *Jersey Cent. Power & Light Co. v. F.E.R.C., supra,*

810 F.2d at p. 1175 [holding that the "used and useful" rule is a "permissible" "tool[] of ratemaking" under the takings clause].) On this point, the superior court is in accord, expressly acknowledging that insureds "need not provide a return on capital which is not required for insurance business" and impliedly acknowledging that insureds need not provide a return on capital that is not actually employed for that purpose. As stated above, it appears that the insurance industry's surplus (i.e., its available capital backing up premiums) is greatly represented by appreciating assets, as opposed to depreciating assets. At one and the same time, surplus surplus—that is, surplus beyond what is useful to back up premiums—inflates the insurer's capital base and any rate set thereon to the disadvantage of its insureds and also produces investment income from appreciating assets. "[I]t surely cannot be reasonable for an investor to assume that each and every [investment] . . . will be [recognized] by regulatory authorities." (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at p. 1193 (conc. opn. of Starr, J.).)

In addition, we do not think it improper for the rate regulations as to rollbacks to take account of investment income on capital used and useful for providing insurance. The observation by the administrative law judge is sound. "[U]nlike other businesses such as public utilities, insurers need not transform their capital into physical assets like a power plant, but may keep them instead in liquid assets like stocks and bonds. Surplus may simultaneously support the insurance business and earn investment income." Certainly, under the "prior approval" system, in the words of Insurance Code section 1861.05, subdivision (a), Proposition 103 expressly requires that the Insurance Commissioner "shall consider whether the rate mathematically reflects the insurance company's investment income." The initiative thereby impliedly requires that the commissioner shall offset the latter against the former. We note that, to the benefit of insurers, the regulations in question take *no* account of investment income on

capital *not* used and useful for providing insurance. They thereby effectively prohibit the commissioner from considering any of such investment income in carrying out the mandate of *Calfarm*, i.e., in determining whether, for the individual insurer, a maximum rate for the rollback year higher than 80 percent of the 1987 rate is required to avoid confiscation and, if so, what such higher maximum rate is. In other words, they prevent a portion of investment income that would otherwise reduce an insurer's maximum rate for the rollback year from doing so.

It bears emphasis that the 10 percent rate of return on the individual insurer's capital base, which is defined as the lower boundary of the range of reasonable rates of return, is not an entitlement conferred by the rate regulations as to rollbacks. It is simply a component of the ratemaking formula. (*Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at p. 948.) Of course, any given rate of return can operate to generate a rate that is much too high or much too low. The result depends directly on how the insurer's capital base is determined and indirectly on how its cost of service is specified. If the capital base is overstated, the defined rate of return will produce a return that is unduly high; if the opposite, the same rate of return will produce a return that is unduly low. Similarly, if the cost of service is inflated, the covering of "expenses" will itself generate a profit without regard to the defined rate of return; if the opposite, the "covering" of expenses will not avoid a loss unless the same rate of return generates an offsetting profit.[16]

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[16] The insurers complain of what they call the ratemaking formula's "rigidity." Their objection seems to be that, in actuality, the formula treats dissimilarly situated insurers similarly. It does not, at least to judge from the orders to show cause issued by the Insurance Commissioner to 14 insurers, including 20th Century, in the matter of their rate rollback liability. It is the insurers themselves that have directed our attention to these orders to show cause.

Not only is the ratemaking formula not internally inconsistent, it is also not confiscatory or arbitrary, discriminatory, or demonstrably irrelevant to legitimate policy.

At this point, we would do well to rehearse, and elaborate on, the principles set out in *Calfarm.*

The Fourteenth Amendment to the United States Constitution provides in relevant part that "[no] state [shall] deprive any person of . . . property, without due process of law. . . ."

"The standard for determining whether a state price-control regulation is constitutional under the Due Process Clause is well established: 'Price control is "unconstitutional . . . if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt. . . ."' " (*Pennell v. San Jose* (1988) 485 U.S. 1, 11, 108 S.Ct. 849, 857, 99 L.Ed.2d 1.) A "legitimate and rational goal of price or rate regulation is the protection of consumer welfare." (*Id.* at p. 13, 108 S.Ct. at 858.)

Such regulation is presumptively constitutional under the due process clause. (See, e.g., *Tenoco Oil Co. v. Dept. of Consumer Affairs* (1st Cir.1989) 876 F.2d 1013, 1022, fn. 15.) "The burden of proving" otherwise "rests on the party asserting the violation. . . ." (*Ibid.*) It "is not easily met. For the last half-century, courts have upheld challenged governmental acts unless no reasonably *conceivable* set of facts could establish a rational relationship between the regulation and the government's legitimate ends." (*Ibid.*, italics in original.) "It is enough that there is an evil at hand for correction, and that it might be thought that the particular . . . measure was a rational way to correct it." (*Williamson v. Lee Optical Co., supra,* 348 U.S. at p. 488, 75 S.Ct. at p. 464 [speaking generally of state regulation of "business and industrial conditions"].)

The Fifth Amendment to the United States Constitution declares as pertinent here that "private property [shall not] be taken for public use without just compensation." This prohibition binds the states through the mandate of the Fourteenth Amendment, quoted above, that "[no] state [shall] deprive any person of . . . property, without due process of law. . . ." (*Chicago, Burlington, etc., R'D v. Chicago* (1897) 166 U.S. 226, 235-241, 17 S.Ct. 581, 584-586, 41 L.Ed. 979.) In other words, the Fifth Amendment's takings clause is enforceable against the states through the Fourteenth Amendment's due process clause.

The takings clause limits the power of the states to regulate, control, or fix prices that producers charge consumers for goods or services. (See, e.g., *Duquesne Light Co. v. Barasch* (1989) 488 U.S. 299, 307-308, 109 S.Ct. 609, 615-616, 102 L.Ed.2d 646.)

"Rate-making is indeed but one species of price-fixing. [Citation.] The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 601, 64 S.Ct. at p. 287.)[17]

The crucial question under the takings clause is whether the rate set is just and reasonable. (See, e.g., *Duquesne Light Co. v. Barasch, supra,* 488 U.S. at pp. 307-308, 109 S.Ct. at pp. 615-616.) If it is not just and reasonable, it is confiscatory. (*Ibid.*) If it is confiscatory, it is invalid. (*Ibid.*) "[I]t is the result reached not the

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[17] *Power Comm'n v. Hope Gas Co., supra,* 320 U.S. 591, 64 S.Ct. 281, which defined the "standards" of the Natural Gas Act of 1938 (52 Stat. 821, 15 U.S.C. § 717 et seq.), effectively delimited the scope of the "requirements" of the United States Constitution: "[T]here are no constitutional requirements more exacting than the standards of the Act. . . ." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 607, 64 S.Ct. at p. 290.)

method employed which is controlling." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 602, 64 S.Ct. at pp. 287-288; see *Duquesne Light Co. v. Barasch, supra,* 488 U.S. at p. 310, 109 S.Ct. at p. 617.) The method may of course be traditional, and may involve case-by-case ratemaking using data reflecting the condition and performance of the regulated firm as an individual entity. But it may also be novel (see *Duquesne Light Co. v. Barasch, supra,* 488 U.S. at p. 316, 109 S.Ct. at p. 620 [stating that the "designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors"]), and may implicate formulaic ratemaking (see *Permian Basin Area Rate Cases* (1968) 390 U.S. 747, 768-770, 88 S.Ct. 1344, 1360-1362, 20 L.Ed.2d 312) using data reflecting the condition and performance of a group of regulated firms (see *id.* at pp. 766-790, 88 S.Ct. at pp. 1359-1371; *Giles Lowery Stockyards v. Dept. of Agriculture* (5th Cir.1977) 565 F.2d 321, 327 ["The 'just and reasonable' principle does not require 'that the cost of each company be ascertained and its rates fixed with respect to its own costs.' [Citation.] It is permissible for an agency to use average costs rather than the costs of individual" regulated firms.]). It is not subject to piecemeal examination: "The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties." (*Duquesne Light Co. v. Barasch, supra,* 488 U.S. at p. 314, 109 S.Ct. at p. 619.) And, of course, courts are not equipped to carry out such a task. (See, e.g., *Harris v. Capital Growth Investors XIV* (1991) 52 Cal.3d 1142, 1166, 278 Cal.Rptr. 614, 805 P.2d 873 [stating that "we are ill equipped to make" "microeconomic decisions"].) "[S]o long as rates as a whole afford [the regulated firm] just compensation for [its] over-all services to the public," they are not confiscatory. (*B. & O.R. Co. v. United States* (1953) 345 U.S.

146, 150, 73 S.Ct. 592, 594-595, 97 L.Ed. 912.) That a particular rate may not cover the cost of a particular good or service does not work confiscation in and of itself. (See *id.* at pp. 147-150, 73 S.Ct. at pp. 593-595.) In other words, confiscation is judged with an eye toward the regulated firm as an enterprise.

The answer to the question whether the rate set is just and reasonable depends on a balancing of the interests of the producers of the goods or services under regulation and the interests of the consumers of such goods or services.

In *Power Comm'n v. Hope Gas Co., supra,* 320 U.S. 591, 64 S.Ct. 281, the court spoke through Justice Douglas.

The *Hope* court made plain that the consumer has a legitimate interest in freedom from exploitation. See *Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 610, 64 S.Ct. at p. 291 [recognizing that "exploitation" of consumers "at the hands of natural gas companies" was an "evil[]"]; see generally, *Power Comm'n v. Pipeline Co.* (1942) 315 U.S. 575, 606-608, 62 S.Ct. 736, 752-753, 86 L.Ed. 1037 (conc. opn. of Black, Douglas, and Murphy, JJ.).)

The *Hope* court also made plain that, for its part, the producer "has a legitimate concern with [its own] financial integrity. . . . From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. [Citation.] By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 603, 64 S.Ct. at p. 288.)

It must be emphasized that the foregoing describes an interest that the producer may pursue and not a right that it can demand. That interest is "only one of the variables in the constitutional calculus of reasonableness." (*Permian Basin Area Rate Cases, supra,* 390 U.S. at p. 769, 88 S.Ct. at p. 1361.) "A regulated [firm] has no constitutional right to a profit. . . ." (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at pp. 1180-1181; accord, *Power Comm'n v. Pipeline Co., supra,* 315 U.S. at p. 590, 62 S.Ct. at p. 745 ["regulation does not insure that the business shall produce net revenues"]; *Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 603, 64 S.Ct. at p. 288, quoting *Power Comm'n v. Pipeline Co., supra,* 315 U.S. at p. 590, 62 S.Ct. at p. 745.) Indeed, such a firm has no constitutional right even against a loss. (See *Market Street R. Co. v. Comm'n* (1945) 324 U.S. 548, 564, 65 S.Ct. 770, 778, 89 L.Ed. 1171 [holding that a rate is not necessarily "confiscatory" even if it "compel[s]" a regulated firm "to operate at a loss"].)[18]

In balancing the relevant producer and consumer interests for a just and reasonable rate, one is concerned with a "broad zone of reasonableness" and not with any particular point therein. (*Permian Basin Area Rate Cases, supra,* 390 U.S. at p. 770, 88 S.Ct. at pp. 1361-1362.) So long as the rate set is within that zone, "there can be no constitutional objection. . . ." (*Ibid.*)

In attempting to balance producer and consumer interests, one may of course arrive at a rate that disappoints one or even both parties. But a striking of the balance to the producer's detriment does not necessarily work confis-

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[18] In *Guaranty Nat. Ins. Co. v. Gates* (9th Cir. 1990) 916 F.2d 508, 515, there is language that may be read to erroneously state that the producer is constitutionally "guarantee[d]" a " 'fair and reasonable return[,]' " and that such a return must necessarily be above the "break even" level. We will not indulge in such a reading.

cation. Indeed, it can *threaten* confiscation only when it prevents the producer from "operating successfully" as that phrase is impliedly defined in prior opinions and is expressly used in this, viz., operating successfully *during the period of the rate and subject to then-existing market conditions.*[19]

The *Hope* court itself expressly held that "[r]ates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return. . . ." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 605, 64 S.Ct. at p. 289.) A year later, the court restated this holding in even simpler terms in a unanimous opinion by Justice Jackson: "a company [cannot] complain if the return which was allowed made it possible for the company to operate successfully." (*Market Street R. Co. v. Comm'n, supra,* 324 U.S. at p. 566, 65 S.Ct. at p. 779.)

The *Hope* court's holding is indisputably vital. Just five years ago, in *Duquesne Light Co. v. Barasch, supra,* 488 U.S. 299, 109 S.Ct. 609, the court, in an opinion by Chief Justice Rehnquist, undertook to "review[] 90 years of" its own "cases concerning . . . rate regulation" (2 Rotunda & Nowak, Treatise on Constitutional Law (2d ed. 1992) § 15.12, p. 504) and then went on to "reaffirm the[] teachings" of *Hope,* quoting in the process the holding set out above (*Duquesne Light Co. v. Barasch, supra,* 488 U.S. at p. 310, 109 S.Ct. at p. 617). Consistently with *Hope,* it effectively defined a "confiscatory" rate thus: "A rate is too low if it is 'so unjust as to destroy the value of [the] property for all the purposes

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[19] Otherwise, the producer could be deemed to be "operating successfully" whenever, for example, it was merely in the position to create a "healthy" cash flow by imprudently liquidating assets amassed in the past or by unreasonably borrowing funds anticipated against the future. That cannot be.

for which it was acquired,' and in so doing 'practically deprive[s] the owner of property without due process of law[.]' " (*Id.* at pp. 307-308, 109 S.Ct. at p. 615, quoting *Covington, etc., Turnpike Co. v. Sandford* (1896) 164 U.S. 578, 597, 17 S.Ct. 198, 205-206, 41 L.Ed. 560.)

Thus, a producer *may* complain of confiscation only if the rate in question does not allow it to operate successfully. This conclusion follows from the *Hope* court's holding that it *cannot* complain if it enables it to operate successfully. (See Tribe, American Constitutional Law (2d ed. 1988) p. 593, fn. 3 [characterizing *Hope* as a "standard that only the most egregiously confiscatory rate structure would have difficulty meeting"].) In a word, the inability to operate successfully is a necessary—but not a sufficient—condition of confiscation.

In *Jersey Central,* the United States Court of Appeals for the District of Columbia Circuit, sitting in bank, and speaking through Judge Bork, explained: "Under *Hope,* . . . the only circumstances under which there is a possibility of a taking of investors' property by virtue of rate regulation is when a [regulated firm] is in the sort of financial difficulty described in Justice Douglas' opinion," viz., "deep financial hardship." (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at p. 1181, fn. 3.) The firm may experience such hardship when it does not earn enough revenue for both "operating expenses" and "the capital costs of the business," including "service on the debt and dividends on the stock," of a magnitude that would allow a "return to the equity owner" that is "commensurate with returns on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 603, 64 S.Ct. at p. 288.) "But absent the sort of deep financial hardship described in *Hope,*" concluded the *Jersey Central* court, "there is no taking. . . ." (*Jersey Cent. Power &*

Light Co. v. F.E.R.C., supra, 810 F.2d at p. 1181, fn. 3.) This follows from the fact that, under *Hope,* a regulated firm may claim that a rate is confiscatory only if the rate does not allow it to operate successfully. In such circumstances, the firm is not inaptly characterized as experiencing "deep financial hardship" as a result of the rate.

Although *Jersey Central* was not unanimous, on this point at least the dissenters were in accord with the majority. "In *Hope,*" stated Judge Mikva, "the Court faced an assertion by the [regulated firm] that the rates fixed by the [regulator] were so low as to be unjust and unreasonable. In testing this challenge, the Court essentially questioned whether the [regulated firm's] shareholders had anything to complain about. The Court examined what was 'important' 'from the investor or company point of view' and found that the rate at issue fully satisfied any legitimate investor interest. [Citation.] Accordingly, the Court held that the rate could not be condemned from the investor viewpoint. [Citation.] One year later, Justice Jackson, speaking for a unanimous court [in *Market Street R. Co. v. Comm'n, supra,* 324 U.S. at page 566, 65 S.Ct. at page 779, restated . . . the Court's holdings in *Hope*: 'All that was held was that a company could not complain if the return which was allowed made it possible for the company to operate successfully.' " (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at p. 1211 (dis. opn. of Mikva, J.).)

When, as here, the question arises whether a regulation is violative of the takings clause on its face, the question is whether its terms preclude the setting of a rate that is just and reasonable as to the regulated firm, and hence nonconfiscatory. (Cf. *Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 816, 258 Cal.Rptr. 161, 771 P.2d 1247 [speaking of a statute]; but see *Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at p. 948 [implying that a regulation is not properly subject to a facial takings challenge either in whole or in part].)

Finally, the law under the due process clause of article I, sections 7 and 15 of the California Constitution and the takings clause of article I, section 19 of that same instrument is in accord with the foregoing principles.

Against this background, the ratemaking formula cannot be deemed arbitrary, discriminatory, or demonstrably irrelevant to legitimate policy. It is demonstrably relevant to the policy of protection of consumer welfare—a policy that the voters were free to adopt, and did in fact adopt, in approving Proposition 103. Further, it is not arbitrary, taking an approach to rates that is a reasonable one, although not the only such approach. Lastly, it is not discriminatory. To the extent that it may be said to disfavor insurers and favor their insureds, it does so well within the limits marked out by due process jurisprudence since at least the late 1930's.

Neither can the ratemaking formula be deemed confiscatory. Its terms do not themselves preclude the setting of a rate that is just and reasonable. Put differently, they do not themselves impose a rate, to quote *Jersey Central,* that inflicts on insurers "the sort of deep financial hardship described in *Hope* . . . ." (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at p. 1181, fn. 3.)

This point is crucial. It deserves special emphasis. The superior court committed fundamental error. At least in the general case, such as this, confiscation does indeed require "deep financial hardship" within the meaning of *Jersey Central,* i.e., the inability of the regulated firm to operate successfully—meaning, again, the inability of the regulated firm to operate successfully *during the period of the rate and subject to then-existing market conditions.* (Accord, *Rural Telephone Coalition v. F.C.C.* (D.C.Cir. 1988) 838 F.2d 1307, 1313 [following *Jersey Central* to hold that "absent 'deep financial hardship . . . there is no taking' "].) Hence, it does *not* arise, as the superior court erroneously believed, whenever a rate simply does not "produce[] a profit which an investor could reasonably

expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital." Profit of that magnitude is, of course, an interest that the producer may pursue. But it is not a right that it can demand. It is "only one of the variables in the constitutional calculus of reasonableness." *Permian Basin Area Rate Cases, supra,* 390 U.S. at p. 769, 88 S.Ct. at p. 1361.) In *FERC v. Pennzoil Producing Co.* (1979) 439 U.S. 508, 518, 99 S.Ct. 765, 772, 58 L.Ed.2d 773, the court declared, with a quotation from *Hope,* that the "notion that [a regulator] is required to maintain, or even allowed to maintain to the exclusion of other considerations, the profit margin of any particular [regulated firm] is incompatible . . . with a basic precept of rate regulation. 'The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid.' "

In concluding that the ratemaking formula cannot be deemed confiscatory on the ground that its terms themselves preclude the setting of a rate that is just and reasonable, we have given special attention to the definition of 10 percent as the lower boundary of the range of reasonable rates of return. The *Fireman's Fund* court considered an argument by insurers, including those here, "that the 10% rate of return set by the Commissioner is the constitutional minimum, and that any improperly disallowed expenses, or improper decreases in the capital base to which the rate of return is applied, have the effect of lowering the rate below the constitutional minimum." (*Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F. Supp. at p. 948.) The court rejected the point. "[The insurers] assume that the Commissioner selected the 10% figure in a vacuum. By itself, the figure has no constitutional dimension. And it is not *res judicata* on the issue of what constitutes the minimum nonconfiscatory rate. As the Commissioner points out, '[t]he 10 percent is not the "end result" of the regulations but merely a component.'

It is the end result that counts." (*Ibid.*) We are in accord.

It must be remembered that the rate regulations as to rollbacks expressly provide for variances as the final mechanism for rate adjustments necessary to avoid confiscation. We believe that if confiscation nonetheless results, it is properly charged against the variances. We shall turn to that question below. (See pt. III.I, *post.*)[20]

In supporting the superior court's conclusion that Proposition 103 does not authorize the Insurance Commissioner to adopt the ratemaking formula in question to implement the rate rollback requirement provision, the insurers make a number of arguments. Most have been anticipated and answered in the preceding discussion. Their ultimate constitutional premise is unsound. To repeat: At least in the general case, such as this, confiscation does indeed require "deep financial hardship" within the meaning of *Jersey Central.* Hence, it does *not* arise, as the superior court erroneously believed, whenever a rate does not "produce[] a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital." Profit of that magnitude is, of course, an interest that the producer may pursue. But it is not a right

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[20] To the extent the superior court determined that the ratemaking formula is confiscatory simply because it is apparently "unique" and without "precedent" among "similar statutes containing the widely used" "excessive"/"inadequate" standard, it erred. Our discussion in the text disposes of the point. "[I]t is the result reached not the method employed which is controlling." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 602, 64 S.Ct. at p. 287.) Indeed, the method may be novel (see *Duquesne Light Co. v. Barasch, supra,* 488 U.S. at p. 316, 109 S.Ct. at p. 620) and implicate formulaic ratemaking (see *Permian Basin Area Rate Cases, supra,* 390 U.S. at pp. 768-770, 88 S.Ct. at pp. 1360-1362) using data reflecting the condition and performance of a group of regulated firms (see *id.* at pp. 766-790, 88 S.Ct. at pp. 1359-1372).

that it can demand. It is "only one of the variables in the constitutional calculus of reasonableness." (*Permian Basin Area Rate Cases, supra,* 390 U.S. at p. 769, 88 S.Ct. at p. 1361.)

The insurers also argue against the ratemaking formula on what appears to be the ground that the United States and/or California Constitutions prohibit the use of such a formula, at least when constitutional rights are implicated. More than 50 years of regulatory jurisprudence in this court and the United States Supreme Court refute the assertion.

The insurers further argue against the ratemaking formula with what appears to be an assertion that the formula may prove to be even more "confiscatory" than the rate rollback requirement provision of Proposition 103 itself. The former offers a possibility of relief from the latter's maximum rate. It simply cannot reduce that rate further.

In addition, the insurers argue against the ratemaking formula thus: the formula improperly looks toward factors including the individual insurer's profits; a proper formula—at least according to 20th Century—would impose general "price caps" on the rates of insurers generally.[21]

We do not think the ratemaking formula improper for looking toward factors including the individual insurer's profits. The insurers say that such an orientation would be proper only in the monopoly or public utility setting, which assertedly does not include the insurance industry. They do not persuade.

The insurers press their position. The gist of their argument is that the voters' approval of Proposition 103 and

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[21] Of course, it must be noted, the ratemaking formula effectively imposes individual "price caps" of a sort on the rates of insurers individually.

their disapproval of other insurance-related measures on the same ballot, especially Proposition 100, reveals an intent to establish a system of regulation that turns out to be remarkably similar to that of "open competition."

The point is urged strongly. But it falls of its own weight.

If nothing else is clear, this is: Proposition 103 was intended to do away with the "open competition" system. The initiative provides for control of rates by means of regulation—initially through the rate rollback, the temporary regulatory regime that operated from November 8, 1988, through November 7, 1989, and then through the "prior approval" system, the permanent regulatory regime that obtains from November 8, 1989, into the future. Such control of rates as may be said to have existed under the "open competition" system was essentially through market forces alone. That the initiative seeks, as it were, to open competition by "repeal[ing] laws that . . . bar banks from selling insurance" (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 841, 258 Cal.Rptr. 161, 771 P.2d 1247 [referring to Prop. 103, Gen. Elec. (Nov. 8, 1988), § 7, reprinted in Ballot Pamp., Proposed Stats. and Amends. to Cal. Const. with arguments to voters, Gen. Elec. (Nov. 8, 1988) p. 141]) does not preserve the "open competition" system. That one of the initiative's purposes is "to encourage a competitive insurance marketplace" (Prop. 103, Gen. Elec. (Nov. 8, 1988), § 2, reprinted in Ballot Pamp., Proposed Stats. and Amends. to Cal. Const. with arguments to voters, Gen. Elec. (Nov. 8, 1988) p. 99) does not deny that another of its purposes is to subject that marketplace to rate regulation. Similarly, that one of the initiative's intermediate goals is the encouragement of a "competitive insurance marketplace" does not deny that its ultimate goal is the guaranty that "insurance is fair, available, and affordable for all Californians." (*Ibid.*)

We agree with the insurers that a ratemaking formula that looks toward factors including the individual insurer's profits would have fit quite easily within the context of Proposition 100. (See Prop. 100, Gen. Elec. (Nov. 8, 1988), § 8, reprinted in Ballot Pamp., Proposed Stats. and Amends. to Cal. Const. with arguments to voters, Gen. Elec. (Nov. 8, 1988) pp. 131-132.)

But we disagree that a ratemaking formula of this sort is out of place in the setting of Proposition 103.

Most broadly stated, the insurers' argument seems to be that under the rate rollback, Proposition 103 requires that rates must be determined, as it were, in the abstract, without consideration in a ratemaking formula or elsewhere of the individual insurer's performance and condition, as revealed in cost of service, capital base, rate of return, etc. That cannot be. As approved by the voters, the initiative in subdivision (b) of Insurance Code section 1861.01 made relief from the rate rollback requirement provision dependent on a substantial threat of "insolvency." "Insolvency" implicates the individual insurer's performance and condition. As construed in *Calfarm*, the initiative makes relief dependent on "confiscation." (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at pp. 816-826, 258 Cal.Rptr. 161, 771 P.2d 1247.) "Confiscation" also implicates the individual insurer's performance and condition.

As to 20th Century's argument for regulation by "price caps" rather than factors including profits, we find persuasive the administrative law judge's response. An argument of this sort is bottomed on "policy" rather than law —specifically, a "policy" that "would have us ignore *Calfarm*'s emphasis on" such factors as profits "and Proposition 103's call for reduction of rates industry-wide," "regardless of whether the rates were low or high by industry standards. . . ." (Italics added in place of underscoring in original.) Under the rate rollback requirement provision—to use the terms appearing in Insurance Code

section 1861.05, subdivision (a)—a rate is "inadequate" if confiscatory and "excessive" if more than minimally nonconfiscatory and above 80 percent of the 1987 rate.

E. *The Validity of the Rate Regulations as to Rollbacks With Respect to the Measurement of Insurer Capital*

The superior court determined that the rate regulations as to rollbacks are not invalid on their face insofar as they require that an insurer's capital be measured in accordance with statutory accounting principles or SAP, which apparently operate to limit the capital base to capital used and useful for providing insurance, instead of generally accepted accounting principles or GAAP.

We agree.

The use of statutory accounting principles, which are more conservative than generally accepted accounting principles, to measure an insurer's capital is altogether appropriate. As stated, statutory accounting principles are "rules that state insurance departments have developed to regulate . . . insurance companies . . . to guarantee their continuing solvency." (*Meyers v. Moody, supra*, 693 F.2d at p. 1218.) To this end, they "mandate" the employment of "conservative methods" in considering and valuing assets "in calculating a company's financial condition. . . ." (*Ibid.*)

That statutory accounting principles apparently operate to limit the insurer's capital base to capital used and useful for providing insurance is unexceptionable. As noted, an insurer's surplus is its available capital backing up premiums. The superior court was right in stating that the Insurance Commissioner could reasonably have concluded that insureds "need not provide a return on capital which is not required for insurance business." The commissioner's underlying position is sound: insureds do not have to pay for what does not give them marginal benefit. Surplus surplus—i.e., surplus beyond what is useful to

back up premiums—inflates the insurer's capital base and any rate set thereon to the disadvantage of its insured, while at the same time it produces investment income from appreciating assets. The superior court was also right in implying that the commissioner could reasonably have concluded that insureds need not provide a return on capital that is not actually employed for insurance business. The commissioner's underlying position is sound here as well: Insureds do not have to pay for what does not give them any benefit whatsoever.

There is certainly nothing confiscatory in the requirement that an insurer's capital be measured in accordance with statutory accounting principles instead of generally accepted accounting principles. (See also *Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at p. 948 [implying that a regulation is not properly subject to a facial takings challenge either in whole or in part].) Neither is there anything arbitrary, discriminatory, or demonstrably irrelevant to the legitimate policy of the protection of consumer welfare.

F. *The Validity of the Rate Regulations as to Rollbacks With Respect to 10 Percent as a Reasonable Rate of Return*

The superior court determined that the rate regulations as to rollbacks are not invalid on their face insofar as they define 10 percent as the lower boundary of the range of reasonable rates of return.

At this point, it may be profitable to call to mind the pertinent findings and conclusions of the administrative law judge: 10 percent as the lower boundary of the range of reasonable rates of return was based "on the average historical rates of return actually achieved by the industry between 1980 and 1989, rather than theoretical investor expectations determined by econometric models"; the "industry earned an average 9.1% return . . . in 1989" under statutory accounting principles, and "over

the 10 years from 1980 to 1989 averaged a 10% return" under both statutory accounting principles and generally accepted accounting principles (internal quotation marks omitted); "[u]se of actual historical rates of return rather than inherently speculative hypothetical projections of investor expectations is . . . reasonable . . ., particularly for a time period now already past."

In making its determination, the superior court applied the appropriate standard of review and proceeded to arrive at the proper conclusion thereunder. Its discussion deserves to be quoted at length.

"[T]he scope of review of the [generic] determinations"—one of which is 10 percent as the lower boundary of the range of reasonable rates of return—"is the arbitrary/capricious standard."

"Determining rates of return is not an exact science, and indeed requires exercise of judgment. The different rates of return found to be reasonable by Commissioner Gillespie and Commissioner Garamendi for the rollback year are an example of how reasonable minds can arrive at different results and how evidence is available to serve as [a] basis for varying conclusions.

". . . Commissioner Garamendi, after 'considering all the evidence presented,' found that [a] . . . rate of return of 10% . . . corresponds to the lower boundary of the range of reasonable returns, and that such a 'rate of return is nonconfiscatory.' [Citation.]

"Evidence supporting the Commissioner's determinations included the testimony of Dr. Andrew Safir, . . . that, in his opinion, 10.3% rate of return . . . was the lower boundary reasonable rate of return. This opinion was based on the individual performance between 1985 and 1989 of a sample of insurers doing business in California" and on a view that "investors' expectations are shaped largely by historic profit levels of the companies making up the industry."

"The validity of Dr. Safir's 10.3% rate of return as at the lower boundary reasonable rate of return was confirmed by other evidence. Thus, his figure was above the level characterized as 'accepted norm' for profitability by A.M. Best Co. [Citation.] [22] Furthermore, during the ten years when the industry average had been 10% return on equity, the surplus grew substantially, and even at that low level the industry had been able to meet debt obligations and pay dividends. [Citations.]

"Dr. Safir looked at a number of companies that earned up to one percent less than his recommended rate of return (between 9.3% and 10.3% . . .), and found that out of 48 such companies, 45 had surplus growth, adding a net $1 billion during the year in which they fell below 10.3%. [Citation.]

"Some of the above was confirmed by 20 Century witness, Dr. Timothy Crichfield. For example, Dr. Crichfield confirmed that most of the surplus growth was from retention of earnings, not attraction of new capital [citations] and that a number of low-earning companies were able not only to retain earnings, but attract capital. [Citations.]

"Further, evidence in the record showed that in 1989 the insurance industry earned an average return of 9.1%

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[22] Dr. Safir testified in part as follows: ". . . I consulted the 1990 [A.M.] Best Key Rating Guide for Property-Casualty Insurance, in order to determine what that company used as an 'accepted norm' for return to policyholders' surplus. The specific rate of return ratio I calculated for rollback purposes, net income after taxes as a percent of average policyholders' surplus, is not used by [A.M.] Best for evaluation purposes. However, it is very close to the test I employed: net income after taxes to prior-year-and policyholders' surplus. [¶] According to [Best's] Key Rating Guide, the acceptable range for this rate-of-return is currently from 3% to 10%. . . ." As the insurers themselves acknowledge through State Farm's representation (see fn. 8, *ante*), "[p]articipants in the [insurance] industry . . . commonly rely on Best's as an accurate factual source and it is well accepted as an accurate and authoritative source of insurance data."

on statutory equity or 9.6% on GAAP [citations]. Over the ten years 1980-1989, the industry averaged 10% return on both SAP and GAAP. Nevertheless, the industry's accumulated capital grew significantly." (Underscoring omitted.)

"The insurers criticize the whole approach of relying on [the] industry's historical average and industry average for 1989 to determine cost of capital for the rollback year. . . .

"There are indeed limitations to the historic average approach. As the insurers point out, the fact that an industry or firm has had low profits for five years or ten years does not necessarily mean that it is a low-risk enterprise or can attract capital even with low rates of return. Similarly, the number of years chosen to include in the average affects the result considerably. Thus, . . . the five-year average is 10.4%, the four-year average 12.4%, and the three-year average 11.8%. Commissioner Garamendi chose a ten-year average in his conclusion. (Commissioner Gillespie previously had used a 15-year average.) Certainly, a rate of return determined on this basis has to be viewed with caution and in the context of other evidence. . . .

"The insurers presented testimony of economists, Dr. [David] Appel and Dr. [James H.] Vander Weide, regarding two theoretical models for estimating investor profit expectations and determination of the return necessary to attract capital: the discounted cash flow model ('DCF') and capital assets pricing model ('CAPM'). These models produced 16.98% and 16.6% rates of return. [Citations.] Depending on assumptions, these rates, too, could vary substantially. [Citation.] Dr. Vander Weide also estimated capital cost based on the risk premium method, arriving at a similar (15.5%) result." "Dr. Vander Weide's range of reasonable returns, based on the DCF model, was between 13.8% and 20.3% [citation]. It is really

rather obvious from the record herein that all models can be manipulated/applied to produce a great range of rates of return."

"The insurers also argued that although utilities are less risky, Pacific Gas and Electric and Southern California Edison were allowed a 13% rate of return in 1989 by the Public Utilities Commission.

"The Commissioner responds that the utilities, unlike insurance companies, hold depreciating assets, and the Public Utilities Commission, unlike the Commissioner, was not looking for a rate at the lower boundary of reasonable rates of return for purposes of determining a one-time rollback.

"In coming to his determination, the Commissioner considered that unlike utilities, insurers do not generally raise capital by attracting investors or borrowing, but primarily by internal growth [citations], and that therefore, such capital acquisition is free of the transactional costs associated with securities markets. In evaluating all of the evidence presented, the Commissioner considered also that unlike utilities, where heavy stock and bond issuances provide market data on cost of capital, only poor market data was available as to insurer cost of capital and, therefore, less credence could be placed on such data by the regulator.

"In concluding that unrealized capital gains must be taken into account in the ratemaking process to 'avoid setting rates higher than appropriate,' the Commissioner again considered the distinction between utilities and insurers. Thus, the Commissioner found that the insurers have been able to attract capital despite returns that lag behind other industries because, unlike other industries, much of their investment value is in appreciating investments. [Citations.] Thus, in 1989, while the property-casualty insurance industry reported a return of 9.6%, its surplus grew 13.1%; while reporting income of $11.2

billion, the insurance companies were increasing in value by $15.5 billion. [Citation.]

"The Commissioner also stressed that the rollback is a one-time event, unlike utilities where the rate of return applies for the indefinite future. A one-year rate of return at the lower end of reasonable rates, he reasoned, is not likely to affect investor expectation so that attracting capital plays a diminished role in the fair rate of return calculus.

"According to the Commissioner, while utility ratemaking is prospective, Proposition 103 rollbacks 'present a rare instance where the financial conditions for the relevant period are known. . . .' [Citation.] His determination to rely on available annual historical industry-wide data, and not rely exclusively on analysts' hypothetical projections on what rates should have been, is not arbitrary and capricious. . . .

"Use of past data, along with other factors, in determining a reasonable rate of return for a past limited period (one year in the case of the rollbacks) is not improper. . . .

"The insurers have pointed to serious flaws in the evidence supporting the Commissioner's determination of 10% as the lower boundary reasonable rate of return. . . .

"Under the arbitrary/capricious standard, however, this court cannot reweigh the evidence and substitute its own judgment for that of the Commissioner.

"The Commissioner considered not only Dr. Safir's opinion testimony, but other evidence in the record as well. He further considered a number of factors which distinguish the insurance business from other businesses, and utilities in particular.

"The court considers all of the factors relied on by the Commissioner"—both "evidence in the record" of File No. RCD-2 and "matters not included" therein under the

rubric of " 'legislative fact[s]' "—"relevant and proper" considerations in setting the lower boundary reasonable rate of return on the range of reasonable rates of return in determining rollbacks. Of particular significance is the fact that the rollback is a one-time event, applicable to a past period and is, thus, less likely to affect future expectations of investors than if all future rates were to be limited by the same 10% lower boundary rate of return.

"Constrained by the narrow scope of its review, this court concludes that there is substantial evidence in the record to support the 10% lower boundary reasonable rate determination for the rollback year, and such determination is not arbitrary or capricious."

The insurers contend that the superior court erred by determining that the rate regulations as to rollbacks are not invalid on their face insofar as they define 10 percent as the lower boundary of the range of reasonable rates of return. They also contend that the superior court erred at the threshold by applying the arbitrary-or-capricious standard of review instead of the independent-judgment-on-the-evidence test.

We reject the latter claim. Our analysis above demonstrates that the arbitrary-or-capricious standard of review is indeed applicable. (See pt. III.B., *ante*.)

We reject the former claim as well. To our mind, the superior court's discussion is persuasive. It establishes that the Insurance Commissioner could properly have defined 10 percent as the lower boundary of the range of reasonable rates of return. The insurers mount an attack based on both the law and the facts. But they simply cannot show that the commissioner acted unreasonably. We note, for example, their strenuous objection to what the superior court called the commissioner's "historic average approach." They maintain in substance that this "approach" cannot determine a *reasonable* rate of return but only an *actual* rate of return. The "historic averages" in question,

however, derive from a period during which the insurance industry was largely unregulated as to rates. Because they do, they reflect a rate of return that the market, at least, would apparently have considered "reasonable." It is true that the "10% return" that "the industry . . . averaged" "over the 10 years from 1980 to 1989" (internal quotation marks omitted) was apparently calculated on its entire capital during that period. Evidently, the insurers would assert, and the commissioner would deny, that all that capital was used and useful for providing insurance. To the extent that the insurers may be understood to complain of the defined rate of return because it is applied to a capital base comprising not their entire capital during the rollback year but only that part that the leverage factor operates to define as used and useful for providing insurance, their complaint is not with the rate of return but actually with the leverage factor. That will be addressed in due course. (See pt. III.H., *post.*) There is certainly nothing confiscatory in the definition of 10 percent as the lower boundary of the range of reasonable rates of return. (See also *Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at p. 948 [implying that a regulation is not properly subject to a facial takings challenge either in whole or in part].) Neither is there anything arbitrary, discriminatory, or demonstrably irrelevant to the legitimate policy of the protection of consumer welfare.

G. *The Validity of the Rate Regulations as to Rollbacks With Respect to the Earthquake Line of Insurance*

The superior court determined that the rate regulations as to rollbacks are invalid on their face insofar as they treat the line of earthquake insurance as they do.

We disagree.

We do not share the superior court's view that the rate regulations as to rollbacks are unsound in that they subject insurers to direct ratemaking.

As the administrative law judge observed, direct ratemaking is an accounting convention; it is used by insurers generally, including 20th Century; and it guarantees consistent treatment of all insurers.

True, direct ratemaking does not recognize an insurer's *expenses for* reinsurance in the form of premiums ceded to a reinsurer. But neither does it recognize the insurer's *revenue from* reinsurance in the form of losses ceded to that same reinsurer. The superior court implied that the nonrecognition of reinsurance expenses offends the takings and due process clauses of the United States and California Constitutions. It appears to have assumed that the insurer must be permitted to recover its entire cost of service—at least insofar as it is reasonable—by operation of one or both of these guaranties. That is not so. A regulated firm may be disallowed an element of its cost of service—even one that is reasonable—without suffering a taking or a denial of due process. The United States Supreme Court has so concluded under the federal charter. (*B. & O.R. Co. v. United States, supra,* 345 U.S. at pp. 147-150, 73 S.Ct. at pp. 593-595.) We come to the same conclusion under that of the state. Any suggestion by the superior court that either organic law controls the choice of accounting conventions must be rejected out of hand.

Neither do we share the superior court's view that the rate regulations as to rollbacks are unsound in that they depend in substantial part on the individual insurer's incurred losses for the rollback year.

Recall that, in this regard, the superior court implied that the rate regulations as to rollbacks violate Proposition 103's proscription of "inadequate" rates in Insurance Code section 1861.05, subdivision (a): calculations are based on the insurer's loss data from a single year; calculations for the earthquake line, however, should be based on loss data from more than one year, because this line (along with others) is one with losses of "low-frequency" but

"high-severity"; calculations for the earthquake line, if based on loss data from a single year with relatively small losses, are skewed to the confiscatory.

We broadly agree with the administrative law judge: The rate regulations as to rollbacks yield generally supportable outcomes for individual insurers, although they disfavor those whose incurred losses are small and favor those whose incurred losses are large; in any event, they do not themselves determine the insurer's rate rollback liability; the minimum permitted earned premium for the earthquake line must not be viewed in isolation as an end result; together with the minimum permitted earned premium for each of the insurer's other lines, it functions only as an intermediate step in the refund calculation.

Nevertheless, we cannot dismiss the concerns of the superior court. Calculations for the earthquake line, if based on loss data from a single year with relatively small incurred losses, do indeed verge toward the low end for any given insurer.

But as stated above, confiscation is judged with an eye toward the regulated firm as an enterprise. That is to say, it depends in this context on the condition of the insurer as a whole—and not on the fortunes of any one or more of its lines, including earthquake.[23] Confiscation may perhaps turn on an insurer's earthquake line if the insurer writes that line alone. But it appears that few insurers, if any, satisfy this condition.

Be that as it may, we state again what we have already stated. The rate regulations as to rollbacks expressly

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[23] In *Calfarm*, we recognized that a court might subsequently be presented with a claim that Proposition 103's maximum rate for the rollback year "is confiscatory as to a particular insurer *and line of insurance*." (*Calfarm Ins. Co. v. Deukmejian, supra*, 48 Cal.3d at p. 825, fn. 18, 258 Cal.Rptr. 161, 771 P.2d 1247, italics added.) Our recognition was factual: it concerns the nature of the complaint that an insurer might make. It was not normative: it does not mean that confiscation is judged other than with an eye toward the insurer as a whole.

provide for variances as the final mechanism for rate adjustments necessary to avoid confiscation. If confiscation nonetheless results, it is properly charged against the variances.(See pt. III.I., *post.*)

Subject to the foregoing, there is nothing confiscatory in the treatment of the line of earthquake insurance. (See also *Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at p. 948 [implying that a regulation is not properly subject to a facial takings challenge either in whole or in part].) Neither is there anything arbitrary, discriminatory, or demonstrably irrelevant to the legitimate policy of the protection of consumer welfare.

H. *The Validity of the Rate Regulations as to Rollbacks With Respect to the Leverage Factor*

The superior court determined that the rate regulations as to rollbacks are invalid on their face insofar as they incorporate the leverage factor.

As stated, the leverage factor is crucial to the determination of rates. The ratemaking formula is designed to yield a premium that the insurer should receive from its insureds in order to earn a sum amounting to (1) the reasonable cost of providing insurance and (2) the capital used and useful for providing insurance multiplied by a fair rate of return. The leverage factor directly contributes to the definition of the capital that is deemed used and useful for providing insurance by inverse relationship: the higher the leverage ratio, the smaller the used-and-useful capital; the lower the leverage ratio, the greater the used-and-useful capital. It follows that the leverage factor indirectly contributes to the setting of the rate itself by inverse relationship: the higher the leverage ratio, the smaller the used-and-useful capital and hence the smaller the rate; the lower the leverage ratio, the greater the used-and-useful capital and hence the greater the rate. Thus, so far as the determination of rates is concerned, the insurer generally favors a lower leverage

ratio and its insureds generally favor a higher leverage ratio.

Expressly and in major part, the superior court's determination of invalidity rests on a finding that the leverage factor is confiscatory.

Confiscation, however, does not appear. The leverage factor functions as an application of the "used and useful" rule. That rule is a "permissible" "tool[] of ratemaking" under the takings clause. (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at p. 1175.) The superior court itself acknowledged explicitly that insureds "need not provide a return on capital which is not required for insurance business." It further acknowledged implicitly that insureds need not provide a return on capital that is not actually employed for that purpose. As explained, to the extent that the leverage factor excludes from recognition capital not used and useful, it also excludes from recognition investment income derived therefrom. (See pt. III.D., *ante.*) The former exclusion is to the insurer's detriment. The latter is to its benefit: it prevents a portion of investment income that would otherwise reduce its maximum rate for the rollback year from doing so.

Nevertheless, in finding the leverage factor confiscatory, the superior court reasoned to this effect: Under the "prior approval" system, the rate regulations "allow[ ] more highly leveraged insurers to use [a lower] 'normative leverage factor' rather than [their] actual [higher] leverage [factor]" in order to obtain a "higher . . . rate of return [*sic:* read, "higher return"] to compensate such insurer[s] for [their] greater risk." They should have done the same under the rate rollback. Because they did not, they "disallow[ ] or disregard[ ] a significant amount of actual 'proper' 1989 surplus. . . ."

The Insurance Commissioner's response is sufficient: "In prior approval the regulations impute to the insurer

the amount of surplus the leverage factors specified in the regulations imply. [Citation.] To the extent that the insurer is more highly leveraged, it will be able to retain extra profit. This provides the insurer with the salutary incentive to write more insurance than it otherwise might, albeit at the cost of somewhat higher risk of insolvency. The Commissioner's decision to use" the specified, rather than the actual, leverage ratio "in prior approval reflects his judgment that the risk is small, particularly when coupled with effective solvency regulation. . . . However, neither the incentive to write more insurance nor the risk of insolvency [is] any longer relevant to 1988-1989 policies, so, for the rollback period, the regulations provide" for the use of "the insurer's actual leverage ratio, as long as the insurer's actual leverage ratio is no less than the leverage ratio adopted in the regulations. If the actual leverage ratio is less, that means that the insurer had more capital than was reasonably necessary to support the insurance, and the insurer is not permitted to extract a profit on the extra surplus from its California policyholders." (Fn. omitted.) Therefore, what the superior court found to be "actual 'proper' 1989 surplus" that is "disallow[ed] or disregard[ed]" is not in fact "actual 'proper' 1989 surplus." It was not "useful" as well as "used."

In any event, the rate regulations as to rollbacks expressly provide for variances as the final mechanism for rate adjustments necessary to avoid confiscation. If confiscation nonetheless results, it is properly charged against the variances. (See pt. III.I., *post*.)

Impliedly and in minor part, the superior court's determination of invalidity rests on a finding that the leverage factor is arbitrary, discriminatory, or demonstrably irrelevant to the legitimate policy of the protection of consumer welfare. Such does not appear. The leverage factor functions as an application of the "used and useful" rule. That rule is permissible under the takings clause.

In our view, it is permissible generally. To be sure, the leverage factor may be said to favor the insured over the insurer. But not unreasonably so.

I. *The Validity of the Rate Regulations as to Rollbacks With Respect to Hearings*

The superior court determined that the rate regulations as to rollbacks are invalid on their face insofar as they preclude an "individualized" hearing on an individual insurer's rate rollback liability: they are "preclusive" (1) because they do not allow a variance or variances sufficient for rate adjustments necessary to avoid confiscation and (2) because they impose the "relitigation bar," which assertedly operates to prevent proof of confiscation in and of itself, even if there were a sufficient variance or variances.

To the extent that the superior court's determination of invalidity is based on the "relitigation bar," it is unsound.

The "relitigation bar," as noted above, is this: "Relitigation in a hearing on an individual insurer's rates of a matter already determined either by these regulations or by a generic determination is out of order and shall not be permitted. However, the administrative law judge shall admit evidence he or she finds relevant to the determination of whether the rate is excessive or inadequate (or, in the case of a proceeding [concerning a rate for the rollback year], relevant to the determination of the minimum nonconfiscatory rate), whether or not such evidence is expressly contemplated by these regulations, provided the evidence is not offered for the purpose of relitigating a matter already determined by these regulations or by a generic determination." (Cal.Code Regs., tit. 10, § 2646.4, subd. (e).)

There is nothing "preclusive" in the "relitigation bar."

That is not to say that the "relitigation bar" is without effect. Its words are plain: "Relitigation in a hearing on an individual insurer's rates of a matter already determined either by these regulations or by a generic determination *is out of order and shall not be permitted. . . .*" (Cal.Code Regs., tit. 10, § 2646.4, subd. (e), italics added.)

Rather, the effect of the "relitigation bar" is unobjectionable. In adjudication, the judge applies declared law; he does not entertain the question whether its underlying premises are sound. That is as it should be. Otherwise, standardless, ad hoc decisionmaking would result. Similarly, in quasi-adjudicatory proceedings, the administrative law judge applies adopted regulations; he does not entertain the question whether their underlying premises are sound. That is also as it should be, and for the same reason. The effect of the "relitigation bar" is simply to assure that, in determining an individual insurer's rate rollback liability, the administrative law judge does not entertain the question whether the premises underlying the rate regulations as to rollbacks are sound. There is, without doubt, nothing novel about such a prohibition. (Cf., e.g., Cal.Code Regs., tit. 22, § 51536 et seq. [setting rates for reimbursement for hospital inpatient services provided to Medi-Cal program beneficiaries]; see especially *id.*, § 51550, subd. (b)(8) [in an administrative adjustment proceeding to challenge certain rate limitations, a provider may not attack the "methodology used to calculate the interim rate"].)

It must be emphasized that in *Calfarm*, we held that Proposition 103's rate rollback requirement provision "is not invalid on its face, but the rates thereby established are necessarily subject to the right of an insurer to demonstrate that a particular rate is, as applied to it, a confiscatory rate." (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 826, 258 Cal.Rptr. 161, 771 P.2d 1247.) Note the right we declared therein: the "right . . . to

demonstrate that a particular rate is, as applied . . . , a confiscatory rate"—not a right to do anything else.[24]

The "relitigation bar" does not prevent proof of confiscation—it does not, in *Calfarm*'s words, deny the insurer its "right . . . to demonstrate that a particular rate is, as applied to it, a confiscatory rate." (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 826, 258 Cal.Rptr. 161, 771 P.2d 1247.) By its very terms, "in the case of a proceeding" concerning a rate for the rollback year, it *requires* admission of evidence found "relevant to the determination of the minimum nonconfiscatory rate. . . ." (Cal.Code Regs., tit. 10, § 2646.4, subd. (e).)

The question is not whether the "relitigation bar" prevents proof of confiscation. It does not. Rather, the question is whether there is a variance or variances sufficient to accommodate such proof. More on this immediately below.

To the extent that the superior court's determination of invalidity is based on the variances, it is also unsound.

There is nothing "preclusive" in the variances.

It is true that, out of eight variances, only three are applicable to rates under the rate rollback: (1) the "one-line" variance; (2) the "entering-the-market" variance; and (3) the "insurer-insolvency" variance. It is also true that the first and second are each of limited availability and the third is demanding.

But the three applicable variances should not be considered, as it were, each in isolation, but rather all together within their full context. There is the ratemaking formula itself. It is designed to yield a nonconfiscatory rate for the individual insurer even before any variance might come into play. Because it has "safety" built in, it does not appear to need "safety valves" different from

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[24] In *Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at page 950, footnote 11, the court effectively found the "relitigation bar" "preclusive." For the reasons stated in the text, it erred.

those provided by the variances. Be that as it may, there is also a separate and independent constitutionally mandated "variance," which was properly recognized by the administrative law judge. It would be available to the individual insurer on proof of confiscation, that is to say, on proof that the regulations in question would otherwise be confiscatory as applied.

In view of the foregoing, variances must be deemed sufficient for rate adjustments necessary to avoid confiscation.

J. *The Validity of the Rate Regulations as to Rollbacks With Respect to Uniform Maximum Rates and Uniform Percentage Refunds*

The superior court determined that the rate regulations as to rollbacks are not invalid on their face insofar as they require a uniform, maximum rate for the rollback year, and a uniform percentage refund of premiums overcharged and overpaid therein, without regard to claimed "excessiveness" or "inadequacy" in individual lines.

We agree.

As construed in *Calfarm,* Proposition 103 expressly requires a uniform, maximum rate for the rollback year—i.e., 80 percent of the 1987 rate *or* such percentage of the 1987 rate greater than 80 percent as is minimally nonconfiscatory.

Contrary to the insurers' claim, any "discrimination" between lines with "excessive" and "inadequate" rates—judged apparently against the minimum permitted earned premiums that are determined only as intermediate steps in the refund calculation—cannot be deemed "unfair." Such "discrimination" was evidently intended by Proposition 103. It is in fact a kind of nondiscrimination: the maximum rate is, uniformly, 80 percent of the 1987 rate or such percentage of the 1987 rate greater than 80 percent as is minimally nonconfiscatory. Be that as it may,

any "discrimination" between lines can hardly be complained of by the insurers. It is they who set the underlying "excessive" and "inadequate" rates. The initiative merely imposes a reduction and freeze on rates it found in place. Any "discrimination" between lines must therefore be attributed to those rates and ultimately to those that set them—the insurers themselves.

As also construed in *Calfarm*, Proposition 103 impliedly requires a uniform percentage refund of premiums charged and paid over the uniform, maximum rate for the rollback year. Otherwise, an insurer might fully refund the overcharged and overpaid premiums by returning to one insured more than had been extracted from him and to another less. This would be an unreasonable result. It would frustrate one of the purposes of the initiative, which is "to protect consumers from arbitrary insurance rates and practices." (Prop. 103, Gen.Elec. (Nov. 8, 1988), § 2, reprinted in Ballot Pamp., Proposed Stats. and Amends. to Cal. Const. with arguments to voters, Gen.Elec. (Nov. 8, 1988) p. 99.) As explained above, whether rates in individual lines could be said to be "excessive" or "inadequate" does not matter. Again contrary to the insurers' claim, any "discrimination" between lines with "excessive" and "inadequate" rates cannot be deemed "unfair."

There is certainly nothing confiscatory in the requirement of a uniform, maximum rate for the rollback year, and a uniform percentage refund of premiums overcharged and overpaid therein. (See also *Fireman's Fund Ins. Co. v. Garamendi, supra*, 790 F.Supp. at p. 948 [implying that a regulation is not properly subject to a facial takings challenge either in whole or in part].) Neither is there anything arbitrary, discriminatory, or demonstrably irrelevant to the legitimate policy of the protection of consumer welfare.[25]

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[25] The insurers may be understood to argue that the rate regulations as to rollbacks may operate to reduce an insurer's maximum

K. *The Validity of the Rate Regulations as to Rollbacks With Respect to Interest*

The superior court determined that the rate regulations as to rollbacks are not invalid on their face insofar as they: (1) require the insurer to pay interest on the dollar amount of premiums overcharged and overpaid for the rollback year; (2) fix the rate of interest at 10 percent per annum, uncompounded; and (3) set the accrual date at May 8, 1988, the midpoint of the rollback year.

We agree with the superior court as to the requirement of interest. Neither the Insurance Commissioner nor the insurers contend otherwise. They could not. In *Calfarm*, we expressly held that "insurer[s] must refund excess premiums collected [for the rollback year] *with interest.*" (*Calfarm Ins. Co. v. Deukmejian, supra,* 48 Cal.3d at p. 825, 258 Cal.Rptr. 161, 771 P.2d 1247, italics added.)

We also agree with the superior court as to the fixing of the rate of interest. The superior court was of the view that the Insurance Commissioner could reasonably have chosen 10 percent as the rate for premiums overcharged and overpaid for the rollback year because the Legislature had chosen the same rate for unearned premiums in Insurance Code section 481.5. We are in accord. To be sure, overcharged and overpaid premiums are not identical to unearned premiums. But they are indeed similar. Unearned premiums are dollars distributed pro rata beyond what has effectively become the term of a policy, as by reason of cancellation. Overcharged and overpaid premiums are, as it were, dollars beyond the policy itself, being in excess of what the insurer could properly have de-

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rate for the rollback year to a point *more than* 20 percent below its 1987 rate, at least in some lines. They treat the minimum permitted earned premium for each line as though it were the maximum rate. As explained in the text, that is not the case. The minimum permitted earned premium for each line functions only as an intermediate step in the refund calculation.

manded. Further, the superior court was of the view that the commissioner is not constrained by article XV, section 1 of the California Constitution. On this point, too, we are in accord. In relevant part, the constitutional provision purports to cover only the maximum rate of interest *on a judgment*—10 percent if set at that level by the Legislature, as it has been in Code of Civil Procedure section 685.010; or 7 percent in the absence of such action by the Legislature. There is no judgment here, but rather a statutory obligation to refund overcharged and overpaid premiums.

The insurers argue to the contrary. They claim that the superior court erred at the threshold by applying the arbitrary-or-capricious standard of review instead of the independent-judgment-on-the-evidence test to the fixing of the rate of interest by the Insurance Commissioner at 10 percent. Our analysis above disposes of the point. (See pt. III.B., *ante*.) They then claim that the superior court erred on the merits by upholding the commissioner in fixing the rate of interest as he did. They do indeed show that imposition of interest at some market rate—the rates they suggest happen to be lower than 10 percent—would have been reasonable. But they do not show that imposition of interest at 10 percent was in fact unreasonable. Without such a demonstration, the point fails. We do not find 10 percent to be an impermissible "penalty" for insurers or an impermissible "windfall" for their insureds.

Finally, we agree with the superior court as to the setting of the accrual date. As with the requirement of interest, neither the Insurance Commissioner nor the insurers contend otherwise. Like the superior court, we believe that the "choice of the midpoint [of the rollback year] is . . . fair to all."

There is nothing confiscatory with respect to the matter of interest. (See also *Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at p. 948 [implying that a

regulation is not properly subject to a facial takings challenge either in whole or in part].) Neither is there anything arbitrary, discriminatory, or demonstrably irrelevant to the legitimate policy of the protection of consumer welfare.

L. *The Validity of the Rate Regulations as to Rollbacks Against Asserted Impermissible "Retroactivity"*

It is unclear whether and to what extent the superior court determined that the rate regulations as to rollbacks are invalid on their face as impermissibly "retroactive." Insofar as it made any such determination, it erred. Our analysis above controls. (See pt. III.C., *ante.*) " 'Primary' retroactivity" does not obtain. " 'Secondary' retroactivity" does, but it is an entirely lawful consequence of rulemaking and hence does not itself offend any law, including the United States and California Constitutions and their respective due process clauses.[26]

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[26] The insurers may be understood to argue that the United States and/or California Constitutions require us to subject the rate regulations as to rollbacks on their face to independent review with regard to method as well as result. The federal charter imposes no such obligation. It "is not designed to arbitrate [such] economic niceties" (*Duquesne Light Co. v. Barasch, supra,* 488 U.S. at p. 314, 109 S.Ct. at p. 619): "it is the result reached not the method employed which is controlling" (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 602, 64 S.Ct. at p. 287). The same is true of the state charter. There can be little doubt that courts "are ill equipped to make" the "multitude of microeconomic decisions" that would be demanded. (*Harris v. Capital Growth Investors XIV, supra,* 52 Cal.3d at p. 1166, 278 Cal.Rptr. 614, 805 P.2d 873.) It makes no difference that the regulations in question implicate federal and state constitutional provisions. *All* regulations do, at least potentially. It may be that in reviewing a rate order, a court "must examine the manner in which the [regulator] has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence." (*Permian Basin Area Rate Cases, supra,* 390 U.S. at p. 792, 88 S.Ct. at p. 1373.)

M. *The Validity of the Rate Regulations as to Rollbacks as Applied to 20th Century and the Effectiveness of the 20th Century Rate Rollback Order*

The superior court determined that the rate regulations as to rollbacks are invalid as applied to 20th Century, and that the 20th Century rate rollback order issued pursuant thereto is void, in the following six particulars: (1) the ratemaking formula itself; (2) 10 percent as the lower boundary of the range of reasonable rates of return; (3) the treatment of the line of earthquake insurance; (4) the variable expense factor; (5) the leverage factor; and (6) the preclusion of an "individualized" hearing on rate rollback liability. It appears that the foregoing determinations have constitutional bases relating to confiscation and

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But we are not yet reviewing a rate order. (See pt. III.M. & fn. 31, *post.*)

Our review of the superior court's determinations concerning the facial validity *vel non* of the rate regulations as to rollbacks persuades us of the general soundness of the regulations. We concluded above that the rate regulations—both generally and specifically as to rollbacks—come within the rate-setting exception, hence fall outside the OAL review requirement, and therefore are not invalid because of OAL disapproval. (See pt. III.A., *ante.*) But proceeding to the merits, for the reasons stated in the text we disagree with the OAL's conclusion that the rate regulations generally are beyond the authority conferred on the Insurance Commissioner by Proposition 103 as construed in *Calfarm* (see Gov.Code, § 11349.1, subd. (a)(2)) and are inconsistent with the initiative's terms (see *id.*, § 11349.1, subd. (a)(4)) on the ground that they impermissibly "restrict an insurer's right to obtain relief from confiscatory rates." We reject an attempt by the insurers to mount a broad, facial challenge to the rate regulations as to rollbacks based on orders to show cause issued by the commissioner to 14 insurers, including 20th Century, in the matter of their rate rollback liability. To quote the commissioner: "An order to show cause functions like an accusation [citation], containing the agency's preliminary assessment of the insurer's rollback liability and ordering the insurer either to refund that amount or to prove otherwise. . . ." It cannot support the weight placed on it by the insurers.

arbitrariness, discrimination, and demonstrable irrelevance to legitimate policy and also statutory bases relating, of course, to Proposition 103.

At the same time, the superior court determined that the rate regulations as to rollbacks are not invalid as applied to 20th Century, and that the 20th Century rate rollback order issued pursuant thereto is not void as to the requirement of a uniform, maximum rate for the rollback year, and a uniform percentage refund of premiums overcharged and overpaid therein, without regard to claimed "excessiveness" or "inadequacy" in individual lines. It appears that the foregoing determination was made on the constitutional and statutory bases identified above.

Before proceeding further, let us state the governing rules. We derive them from the discussion set out above. (See pt. III.D., *ante.*)

When a regulation is challenged as violative of the due process clause as applied, the question is whether, in the particular case, it is arbitrary, discriminatory, or demonstrably irrelevant to legitimate policy.

The same analysis is called for when a rate order itself is challenged as violative of the due process clause.

When a regulation is challenged as violative of the takings clause as applied, the question is whether, in the particular case, its terms set a rate that is unjust and unreasonable and hence confiscatory.

When a rate order itself is challenged as violative of the takings clause, "the question is whether that order 'viewed in its entirety' meets the [relevant] requirements. . . . Under the . . . standard of 'just and reasonable' it is the result reached not the method employed which is controlling. [Citations.] It is not theory but the impact of the rate order which counts." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 602, 64 S.Ct. at pp. 287-288; accord, *Duquesne Light Co. v. Barasch,*

supra, 488 U.S. at p. 310, 109 S.Ct. at p. 617.) The regulator is not bound "to the service of any single formula or combination of formulas." (*Power Comm'n v. Pipeline Co., supra,* 315 U.S. at p. 586, 62 S.Ct. at p. 743; accord, *Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 602, 64 S.Ct. at pp. 287-288.) It is "free . . . to make the pragmatic adjustments which may be called for by particular circumstances." (*Power Comm'n v. Pipeline Co., supra,* 315 U.S. at p. 586, 62 S.Ct. at p. 743; accord, *Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 602, 64 S.Ct. at pp. 287-288.)

Judicial inquiry as to whether or not a rate is just and reasonable is necessarily difficult. More than 25 years ago, in *Permian Basin Area Rate Cases, supra,* 390 U.S. 747, 790, 88 S.Ct. 1344, 1372, 20 L.Ed.2d 312, the court declared: "[N]either law nor economics has yet devised generally accepted standards for the evaluation of rate-making orders. . . ." The declaration was valid then. It remains valid now. (See *Duquesne Light Co. v. Barasch, supra,* 488 U.S. at p. 308, 109 S.Ct. at p. 616, citing and quoting *Permian Basin Area Rate Cases, supra,* 390 U.S. at p. 790, 88 S.Ct. at p. 1372.)

Judicial inquiry as to whether or not a rate is just and reasonable is also limited. Indeed, it "is at an end" "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable. . . . The fact that the method employed to reach that result may contain infirmities is not then important." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 602, 64 S.Ct. at p. 288; accord, *Duquesne Light Co. v. Barasch, supra,* 488 U.S. at p. 310, 109 S.Ct. at p. 617.) "[H]e who would upset the rate order . . . carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 602, 64 S.Ct. at p. 288.)

The *Hope* court identified one situation in which "he who would upset the rate order" could not bear that

"heavy burden." "Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainty cannot be condemned as invalid, even though they might produce only a meager return. . . ." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 605, 64 S.Ct. at p. 289; accord, *Duquesne Light Co v. Barasch, supra,* 488 U.S. at p. 310, 109 S.Ct. at p. 617.) More simply, "a company [cannot] complain if the return which was allowed made it possible for the company to operate successfully." (*Market Street R. Co. v. Comm'n, supra,* 324 U.S. at p. 566, 65 S.Ct. at p. 779.)

We believe principles substantially similar to the foregoing control when a regulation is challenged as violative of Proposition 103 as applied, and when a rate order itself is challenged as offensive to the initiative.

Let us turn to the task at hand.

On one matter alone, the superior court accepted the position of the Insurance Commissioner. As stated, it determined that the rate regulations as to rollbacks are not invalid as applied to 20th Century, and that the 20th Century rate rollback order issued pursuant thereto is not void, as to the requirement of a uniform, maximum rate for the rollback year, and a uniform percentage refund of premiums overcharged and overpaid therein, without regard to claimed "excessiveness" or "inadequacy" in individual lines. This is sound. The analysis supporting our conclusion concerning the facial validity of the regulations in this regard is applicable here as well. (See pt. III.J., *ante.*) 20th Century's situation does not require an exception.

On the other matters, the superior court rejected the position of the Insurance Commissioner. We shall consider the points seriatim.

The superior court determined that the rate regulations as to rollbacks are invalid as applied to 20th Century, and that the 20th Century rate rollback order issued pursuant thereto is void, with respect to the ratemaking formula itself.

This is error.

The determination is based on the belief that confiscation does not require "deep financial hardship" within the meaning of *Jersey Central.* It does, at least in the general case, such as this. This erroneous belief fatally taints the conclusion in question—directly, insofar as it rests on the constitutional ground of confiscation; and indirectly, insofar as it rests on the constitutional ground of arbitrariness, discrimination, and demonstrable irrelevance to legitimate policy and also on the statutory grounds.

In addition, the determination depends on the facial *invalidity* of the rate regulations as to rollbacks with respect to the ratemaking formula. In this regard, however, the regulations in question are facially *valid.* (See pt. III.D., *ante.*) 20th Century's situation does not require an exception.

The superior court also determined that the rate regulations as to rollbacks are invalid as applied to 20th Century, and that the 20th Century rate rollback order issued pursuant thereto is void, with respect to 10 percent as the lower boundary of the range of reasonable rates of return.

This too is error.

The determination is fatally tainted by the erroneous belief that confiscation does not require "deep financial hardship" within the meaning of *Jersey Central,* not even in the general case, such as this.

Moreover, the determination is unsound in and of itself.

The underlying reasoning appears to be that the lower boundary of the range of reasonable rates of return for

a regulated firm is its cost of capital—which for 20th Century was found to be at least 20 percent.

One assumption seems to be that a regulated firm is entitled to its cost of capital. Although such a firm has an interest in this matter, it has no right. (See *Permian Basin Area Rate Cases, supra,* 390 U.S. at p. 769, 88 S.Ct. at p. 1361 [stating that "[r]egulation may, consistently with the [United States] Constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness"]; *id.* at p. 791, 88 S.Ct. at p. 1372 [implying that, accordingly, the regulator "cannot confine its inquiries . . . to conjectures about the prospective responses of the capital market"].)[27] The United States and California Constitutions make the point plain. As stated, a regulated firm has no constitutional right even against a loss. Manifestly, Proposition 103 is not to the contrary.

Another assumption seems to be that cost of capital is dispositive as to the issue here, which concerns rate rollback liability. Although cost of capital, to quote the administrative law judge, may be "pertinent for prospective ratemaking" under the "prior approval" system, "implementation of the rollback does not require prospective ratemaking but rather the determination of a minimum nonconfiscatory return for a period now past." (Internal quotation marks omitted.)

It must be emphasized that the evidence of 20th Century's cost of capital appears to derive from a period during which 20th Century, like other insurers, was

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[27] *Tennessee Gas Pipeline Co. v. F.E.R.C.* (D.C.Cir.1991) 926 F.2d 1206, on which 20th Century and the other insurers rely, is not to the contrary. That the Federal Energy Regulatory Commission might "endeavor[] to set a utility's rate of return on equity at its cost of equity capital" as a matter of policy (*id.* at p. 1208) does not mean that another regulator must do the same under constitutional compulsion.

largely unregulated as to rates. To accord such evidence compelling weight would effectively exempt 20th Century from rate regulation. A result of this sort is barred by Proposition 103. It is not commanded by any other provision of law, including the United States and California Constitutions. (See *FERC v. Pennzoil Producing Co., supra,* 439 U.S. at p. 518, 99 S.Ct. at p. 772 [declaring, with a quotation from *Hope,* that: The "notion that [a regulator] is required to maintain, or even allowed to maintain to the exclusion of other considerations, the profit margin of any particular [regulated firm] is incompatible . . . with a basic precept of rate regulation. 'The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid.' "].)

The superior court was of the view that the rate regulations as to rollbacks as applied to 20th Century, and the 20th Century rate rollback order issued pursuant thereto, improperly preclude a rate covering 20th Century's cost of service plus 10 percent of its capital base, in spite of the definition of 10 percent as the lower boundary of the range of reasonable rates of return. Contrary to its evident assumption, any such preclusion is not improper in and of itself: the ratemaking formula does not purport to guarantee the individual insurer a rate covering its cost of service plus 10 percent of its capital base independent of the various adjustments, exclusions, etc., incorporated therein. (See *Fireman's Fund Ins. Co. v. Garamendi, supra,* 790 F.Supp. at p. 948.)

The superior court determined as well that the rate regulations as to rollbacks are invalid as applied to 20th Century, and that the 20th Century rate rollback order issued pursuant thereto is void, with respect to the treatment of the line of earthquake insurance.

This too is error.

The determinaton is fatally tainted by the erroneous belief about confiscation.

Moreover, the determination depends on the facial *invalidity* of the rate regulations as to rollbacks with respect to the treatment of the line of earthquake insurance. In this regard, however, the regulations in question are facially *valid*. (See pt. III.G., *ante*.) 20th Century's situation does not require an exception. That applies to the fact that the regulations subject 20th Century to direct ratemaking. It also applies to the fact the regulations depend in substantial part on 20th Century's incurred losses for the rollback year, which were relatively small. To our mind, the regulations yield a generally supportable outcome for 20th Century, although treating it unfavorably because its incurred losses for the rollback year were relatively small. In any event, they do not themselves determine 20th Century's rate rollback liability. The minimum permitted earned premium for the earthquake line must not be viewed in isolation as an end result. Together with the minimum permitted earned premium for each of 20th Century's five other lines, it functions only as an intermediate step in the refund calculation.

Further, the determination falls insofar as it rests on the constitutional basis of confiscation. The assumption appears to be that confiscation can be effected within 20th Century's line of earthquake insurance in and of itself. Not so. As stated above, confiscation is judged with an eye toward the regulated firm as an enterprise. In this context, it depends on the condition of the insurer as a whole—and not on the fortunes of any one or more of its lines, including earthquake. That confiscation may perhaps turn on an insurer's earthquake line if the insurer writes that line alone is of purely theoretical interest. The fact is, 20th Century does not satisfy the condition, since it writes five lines in addition to earthquake. We recognize that calculations for 20th Century's earthquake line, since they are based on loss data from a single year with

relatively small incurred losses, do indeed verge toward the low end. But that is not enough.

The observation of the administrative law judge bears repeating: "The component of the rollback calculation related to 20th Century's Earthquake line may appear somewhat harsh when it is viewed in isolation. . . , as if it were the final result rather than only an intermediate step in the calculation. However, 20th Century's rollback must be judged on the issue of confiscation based on the overall result. [Citation.] From that perspective, the impact is not confiscatory. [Citation.] 20th Century is a multi-line insurer whose Earthquake line accounted for only 1.35 percent of its business ($8.7 million of $641.7 million) in the rollback year, and its unrecognized reinsurance premiums on Earthquake only accounted for 0.7 percent of its business ($4.5 million of $641.7 million). [Citation.] It admittedly suffered very low losses in its Earthquake line that year and its cost of writing that coverage was small (estimated . . . to be as low as five dollars per policy, [citation]), so it enjoyed a high profit in that line. In any case, calculation of the Earthquake component of the rollback is merely one of the many intermediate steps to the final rollback." (Fn. omitted.) So far as the earthquake line is concerned, the "final rollback" amounts to 12.203 percent of $8.7 million or $1.06 million.[28]

The superior court also determined that the rate regulations as to rollbacks are invalid as applied to 20th Century, and that the 20th Century rate rollback order issued pursuant thereto is void, with respect to the variable expense factor.

This too is error.

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[28] In this court, 20th Century attempts to incorporate into the analysis of the treatment of its earthquake line the treatment of its "other liability" and "inland marine" lines. Such incorporation does not affect the result.

The determination is fatally tainted by the erroneous belief about confiscation.

Moreover, the determination is unsound in and of itself. The variable expense factor is the sum of the commission rate and the state premium tax rate. Within the ratemaking formula, it functions to recognize only such amount of commissions and state premium taxes as are attributable to the maximum rate for the rollback year set by Proposition 103 as construed in *Calfarm*. The superior court thought this objectionable. It is not. Otherwise, a rate above the maximum would tend to justify itself—surely an untenable result. It is not unreasonable to fail to recognize that amount of commissions and state premium taxes that would have been avoided had 20th Century charged a rate at or below the maximum for the rollback year.

The superior court determined as well that the rate regulations as to rollbacks are invalid as applied to 20th Century, and that the 20th Century rate rollback order issued pursuant thereto is void, with respect to the leverage factor.

This too is error.

The determination is fatally tainted by the erroneous belief about confiscation.

Moreover, the determination depends on the facial *invalidity* of the rate regulations as to rollbacks with respect to the leverage factor. In this regard, however, the regulations are facially *valid*. (See pt. III.H., *ante*.) 20th Century's situation, which appears to involve high leverage, does not require an exception. The leverage factor apparently excluded from recognition about $12 million of 20th Century's capital. It also apparently excluded from recognition about $1 million of the firm's investment income derived therefrom. It thereby apparently prevented that portion of the firm's investment income that would otherwise have reduced its maximum rate for the

rollback year from doing so. As a result, the firm apparently experienced a net benefit.

The superior court also determined that the rate regulations as to rollbacks are invalid as applied to 20th Century, and that the 20th Century rate rollback order issued pursuant thereto is void, with respect to the preclusion of an "individualized" hearing on the firm's rate rollback liability.

This too is error.

At the threshold, we observe that in making its determination the superior court concluded that the administrative law judge erred by holding that confiscation requires "deep financial hardship" within the meaning of *Jersey Central*. It is rather the superior court that erred. Confiscation does indeed so require, at least in the general case, such as this.

In part, the determination depends on the facial *invalidity* of the rate regulations as to rollbacks with respect to the "relitigation bar." In this regard, however, the regulations are facially *valid*. (See pt. III.I., *ante*.) 20th Century's situation does not require an exception. All the same, what we stated previously bears repeating now: the administrative law judge effectively lifted the "relitigation bar" to allow 20th Century to introduce evidence to challenge the premises of the regulations in question.

In other part, the determination depends on the facial invalidity of the rate regulations as to rollbacks with respect to the absence of a variance or variances sufficient for rate adjustments necessary to avoid confiscation. In this regard, too, the regulations are facially *valid*. (See pt. III.I., *ante*.)

As noted, included in the superior court's determination concerning the preclusion of an "individualized" hearing on 20th Century's rate rollback liability is a finding of

fundamental unfairness in the conduct of the hearing. To the extent that this finding is based on the superior court's conclusion that the administrative law judge erred by holding that confiscation requires "deep financial hardship" within the meaning of *Jersey Central*—this seems the ultimate if not sole ground—it fails. Again, it is the superior court that erred and not the administrative law judge. To the extent that this finding is based on anything other than that conclusion, it fails as well. We have examined the conduct of the hearing, and have decided that it was fundamentally fair and otherwise in accordance with law.

It is unclear whether and to what extent the superior court determined that the rate regulations as to rollbacks are invalid as applied to 20th Century as impermissibly "retroactive." Insofar as it made any such determination, it erred. Our analysis above controls. (See pt. III.C., *ante*.) " 'Primary' retroactivity" does not obtain. " 'Secondary' retroactivity" does, but it is an entirely lawful consequence of rulemaking and hence does not itself offend any law, including the United States and California Constitutions and their respective due process clauses.[29]

Implicit in the superior court's decision is its ultimate determination that the 20th Century rate rollback order is unjust and unreasonable in its consequences and therefore confiscatory.

This is the superior court's ultimate error. Indeed, it is this determination that is most fatally tainted by its erroneous belief that confiscation does not require "deep financial hardship" within the meaning of *Jersey Central*, not even in the general case, such as this.

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[29] The insurers may be understood to argue that the United States and/or California Constitutions require us to subject the rate regulations as to rollbacks as applied to independent review with regard to method as well as result. Neither the federal charter nor that of the state imposes such obligation. (See also fn. 26, *ante*.)

The analysis set out above establishes that the question whether the 20th Century rate rollback order is unjust and unreasonable in its consequences and therefore confiscatory depends on a balancing of the interests of 20th Century and its insureds. (See pt. III.D., *ante.*)

The interest of 20th Century's insureds, simply put, is in freedom from exploitation.

By contrast, the interest of 20th Century itself is in having enough revenue for both "operating expenses" and "the capital costs of the business," including "service on the debt and dividends on the stock," of a magnitude that would allow a "return to the equity owner" that is "commensurate with returns on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 603, 64 S.Ct. at p. 288.)

20th Century's interest, however, is just that: it is an *interest,* not a *right.* It is "only one of the variables in the constitutional calculus of reasonableness." (*Permian Basin Area Rate Cases, supra,* 390 U.S. at p. 769, 88 S.Ct. at p. 1361.) 20th Century "has no constitutional right to a profit. . . ." (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at pp. 1180-1181.) Indeed, it has no constitutional right even against a loss.

It is apparently at this point that the superior court veered onto its path of error, mistaking what is an interest that 20th Century may pursue for a right that it can demand.

To determine whether the 20th Century rate rollback order is unjust and unreasonable in its consequences and therefore confiscatory, the superior court should have asked "whether that order 'viewed in its entirely' meets the requirements" of the balancing of interests identified above. (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p.

602, 64 S.Ct. at p. 287.) "Under the . . . standard of 'just and reasonable' it is the result reached not the method employed which is controlling. [Citations.] It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry . . . is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." (*Ibid.*)

And in determining whether the 20th Century rate rollback order is unjust and unreasonable in its consequences and therefore confiscatory, the superior court should of course have focused *on its consequences.* They are these: 20th Century was ordered to refund to each insured an amount equal to the premiums paid for the rollback year multiplied by a refund percentage of 12.203 percent, with simple interest calculated at 10 percent per annum from May 8, 1989, to the date of payment. 20th Century's maximum rate for the rollback year was effectively set at about 98.89 percent of the 1987 rate to avoid confiscation, rather than at 80 percent of that rate, as required by Proposition 103 in the rate rollback requirement provision. Put differently, 20th Century's maximum rate for the rollback year was reduced to a point a mere 1.11 percent below its 1987 rate, rather than to a point 20 percent below that rate.[30]

In view of the foregoing, it cannot be said that 20th Century "carrie[d] [its] heavy burden of making a convincing showing that [its rate rollback order] is invalid because it is unjust and unreasonable in its consequences." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 602, 64 S.Ct. at p. 288.)

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[30] 20th Century may be understood to claim that its maximum rate for the rollback year was reduced to a point *more than* 20 percent below its 1987 rate (at least in some lines), contrary to the rate rollback requirement provision of Proposition 103. Such an assertion must be dismissed as baseless.

That is because such a showing is precluded when, as here, the "return which was allowed made it possible for the company to operate successfully." (*Market Street R. Co. v. Comm'n, supra,* 324 U.S. at p. 566, 65 S.Ct. at p. 779; accord, *Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 605, 64 S.Ct. at p. 289.)

20th Century did indeed operate successfully during the rollback year. It practically admits as much. It asserts that its "rate of growth throughout the years since it was founded in 1958"—including the period extending from November 8, 1988, through November 7, 1989—has been "phenomenal."

From all that appears, 20th Century would have operated successfully during the rollback year *under, and in spite of, the rate rollback.* Its growth would surely have been slowed down. But as the administrative law judge stated, it "has cited no case holding that a slowdown in growth is confiscatory." Put otherwise, its business would have been "less prosperous as a result of" the rate rollback. (*California Auto. Assn. v. Maloney, supra,* 341 U.S. at p. 111, 71 S.Ct. at 604.) Such a "diminution in value, however, has never mounted to the dignity of" confiscation. (*Ibid.*)

Since the "total effect" of the 20th Century rate rollback order "cannot be said to be unjust and unreasonable," our "inquiry . . . is at an end." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 602, 64 S.Ct. at p. 288.) To go further would lead us to "micromanage the rate regulation process. . . ." (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at p. 1191 (conc. opn. of Starr, J.).) That is not our function. (*Ibid.*) It is clear beyond peradventure that "[w]e are not obliged to examine each detail of the [Insurance Commissioner's] decision. . . ." (*Permian Basin Area Rate Cases, supra,* 390 U.S. at p. 767, 88 S.Ct. at p. 1360.) We will not do so.

To prove confiscation, 20th Century frames an argument that compares the amount of the refund of premiums required by its rate rollback order, which the superior court found to be about $78 million (plus interest), with the amount of its after-tax revenue for 1989, which the superior court found to be about $76 million.

At first glance, the argument appears substantial. The comparison between about $76 million coming in and about $78 million going out seems to show a loss of about $2 million.

On closer consideration, however, the argument turns out to be specious. With matching, an appropriate comparison would account for *both* the revenue "forgone" by 20th Century, i.e., the amount of the refund of premiums required by its rate rollback order, which the superior court found to be about $78 million, *and* the expenses "avoided" by 20th Century, including federal income tax, state premium tax, and commissions, which appear to be about $29 million. Under such a comparison, there is a profit of about $27 million—representing a rate of return of about 11 percent on what 20th Century declared to be a capital base of about $243 million (equaling its mean 1989 surplus calculated in accordance with statutory accounting principles). With a profit and rate of return of this magnitude, confiscation does not appear.

In effect, 20th Century objects that it must "really" "forgo" revenue in the amount of $78 million but that it does not "really" "avoid" expenses in the amount of $29 million. This seems an effort to defeat matching by accepting accounting conventions that are favorable and rejecting those that are not. More fundamentally, it seems an effort to obtain a "reward" for having charged a rate for the rollback year higher than the Proposition 103's maximum rate of 80 percent of the 1987 rate. (See pt. III.D., *ante*.) In any event, let us recall that 20th Century, in attempting to upset its rate rollback order, "carries the heavy burden of making a convincing showing that it

is invalid because it is unjust and unreasonable in its consequences." (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 602, 64 S.Ct. at p. 288.) In the context of its objection, 20th Century would apparently have to prove that it could not recover the expenses in question, i.e., federal income tax, state premium tax, and commissions. It fails to do so. Indeed, all indications in the record are to the contrary.

We may observe in passing that 20th Century does not make an argument for confiscation based solely on the fact that its rate rollback order requires it to refund premiums and to pay interest thereon. The reason is manifest. It is called equity. The refund puts 20th Century and its insureds into the situation they would each have occupied had the former not overcharged the latter and the latter not overpaid the former. (See pt. III.D., *ante.*) Similarly with respect to the payment of interest.

It follows from what has preceded that there is nothing in the 20th Century rate rollback order that is arbitrary, discriminatory, or demonstrably irrelevant to the legitimate policy of the protection of consumer welfare.[31]

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[31] Our review of the superior court's determinations concerning the validity *vel non* of the rate regulations as to rollbacks as applied to 20th Century persuades us that they are generally sound.

In reviewing the 20th Century rate rollback order, although "not obliged to examine each detail" (*Permian Basin Area Rate Cases, supra,* 390 U.S. at p. 767, 88 S.Ct. at p. 1360), we have in fact "examine[d] the manner in which the [Insurance Commissioner] has employed the methods of regulation which [he] has [himself] selected, and [have] decide[d] [that] each of the order's essential elements is supported by substantial evidence" (*id.* at p. 792, 88 S.Ct. at p. 1373).

We note that the superior court denied "as moot" a motion made by 20th Century in *20th Century II* "to admit expert rebuttal testimony and/or [take] judicial notice [of such testimony]" (capitalization changed to lower case) relating to its cost of capital. (We should also note that the superior court expressed its view that "[a]s far as the judicial notice is concerned, it does seem to me that this is really not the type of matter that is prop-

IV. DISPOSITION

For the reasons stated above, we conclude that we must reverse the judgment of the superior court and direct that court to render judgment in favor of the Insurance Commissioner and Voter Revolt and against 20th Century, Hartford, State Farm, et al.

It is so ordered.

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erly judicially noticed. . . .") There is no need to remand the cause for redetermination. The "testimony" in question was essentially cumulative in substance if not in form. It was without marginal significance. Indeed, it should probably have been excluded under Evidence Code section 352 on the ground that its admission would have "necessitate[d] undue consumption of time. . . ."

LUCAS, C.J., and KENNARD, ARABIAN, BAXTER, GEORGE, WERDEGAR, JJ., concur.

MOSK, Justice, concurring.

I concur, of course, in the opinion that I have prepared for the court. Specifically, I concur in its conclusion that neither Proposition 103's rate rollback requirement provision nor the rate regulations as to rollbacks are facially confiscatory under the takings clause of the Fifth Amendment to the United States Constitution.

I write separately to address the following question:

Can any individual insurer, through either the operation of Proposition 103's rate rollback requirement provision or the rate regulations as to rollbacks, suffer confiscation under the takings clause of the Fifth Amendment?

Evidently, *No.*

"It is well established that the Takings Clause of the Fifth Amendment applies to so-called 'regulatory takings[]' " effected by government price regulation. (*Garelick v. Sullivan* (2d Cir.1993) 987 F.2d 913, 916.)

"It is" equally "well established that government price regulation does not constitute a taking of property where the regulated group is not required to participate in the regulated industry. *See, e.g., Bowles v. Willingham,* 321 U.S. 503, 517-18, 64 S.Ct. 641, 648-49, 88 L.Ed. 892 (1944) (rent controls do not constitute prohibited taking because statute does not require landlords to offer their apartments for rent); *Minnesota Ass'n of Health Care Facilities, Inc.* [*v. Minnesota Department of Public Welfare*], 742 F.2d [442,] 446 [(8th Cir.1984)] (state statute limiting fees nursing homes participating in Medicaid Program may charge to non-Medicaid patients is not taking within meaning of the Fifth Amendment because 'the state does not require that nursing homes admit medical assistance residents and participate in the Medic-

aid Program')." (*Whitney v. Heckler* (11th Cir.1986) 780 F.2d 963, 972, parallel citations omitted.)

"A property owner must be legally compelled to engage in price-regulated activity for regulations to give rise to a taking. *See Bowles v. Willingham,* 321 U.S. 503, 517-18, 64 S.Ct. 641, 648-49, 88 L.Ed. 892 (1944); *Whitney v. Heckler,* 780 F.2d 963, 972 (11th Cir.), *cert. denied,* 479 U.S. 813, 107 S.Ct. 65, 93 L.Ed.2d 23 (1986); *Minnesota Ass'n of Health Care Facilities v. Minnesota Dep't of Pub. Welfare,* 742 F.2d 442, 446 (8th Cir. 1984), *cert. denied,* 469 U.S. 1215, 105 S.Ct. 1191, 84 L.Ed.2d 337 (1985). For example, public utilities are under a state statutory duty to serve the public and must furnsh 'service on demand to all applicants' at government-determined rates. W. Pond, *The Law Governing the Fixing of Public Utility Rates: A Response to Recent Judicial and Academic Misconceptions,* 41 Admin.L.Rev. 1, 5 (1989) (hereinafter 'Pond'); *see also Duquesne Light Co. v. Barasch,* 488 U.S. 299, 307, 109 S.Ct. 609, 615, 102 L.Ed.2d 646 (1989). Because utilities generally are compelled to employ their property to provide services to the public, the Fifth Amendment requires regulators to provide utilities with reasonable compensation for their services. *See Minnesota Ass'n,* 742 F.2d at 446; *see also* Pond, *supra,* at 5.

"By contrast, where a service provider voluntarily participates in a price-regulated program or activity, there is no legal compulsion to provide service and thus there can be no taking. *See Bowles,* 321 U.S. at 517-18, 64 S.Ct. at 648-49; *Burditt v. United States Dep't of Health and Human Servs.,* 934 F.2d 1362, 1376 (5th Cir.1991); *Whitney,* 780 F.2d at 972; *Minnesota Ass'n,* 742 F.2d at 446; *Texaco Puerto Rico, Inc. v. Ocasio Rodriguez,* 749 F.Supp. 348, 359 (D.P.R.1990); *Anco, Inc. v. State Health and Human Servs. Fin. Comm.,* 300 S.Ct. 432, 441-42, 388 S.E.2d 780, 786 (1989). Thus, in *Bowles v. Willingham,* the Supreme Court sustained a rent regula-

tion ordinance because the statute did not require that plaintiff landlords remain in the business of renting apartments. The landlords were free to keep their buildings vacant and/or to dispose of their properties on the market (albeit at prices depressed by the rent regulations) without being subject to government price regulations. Consequently, the statute at issue did not give rise to a regulatory taking. *See* 321 U.S. at 517-18, 64 S.Ct. at 648-49; *see also St. Francis Hosp. Ctr. v. Heckler,* 714 F.2d 872, 884 (7th Cir.1983) (per curiam) (diminishment of market value resulting from regulation will not give rise to taking where property owner retains 'full rights and control over . . . net investment'), *cert. denied,* 465 U.S. 1022, 104 S.Ct. 1274, 79 L.Ed.2d 679 (1984)." (*Garelick v. Sullivan, supra,* 987 F.2d at p. 916, parallel citations omitted.)

A "service provider" may be said to "voluntarily participat[e] in a price-regulated program or activity" (*Garelick v. Sullivan, supra,* 987 F.2d at p. 916) when it has the "right to withdraw" therefrom (*Texaco Puerto Rico, Inc. v. Ocasio Rodriguez* (D.P.R. 1990) 749 F.Supp. 348, 372, italics and initial capitalization omitted; accord, *id.* at p. 359). Such a right exists even when, "as a practical and financial matter, withdrawal would be enormously costly. . . . *Permian* [*Basin Area Rate Cases* (1968) 390 U.S. 747, 88 S.Ct. 1344, 20 L.Ed.2d 312] teaches that [government price regulation] may so stringently limit profits that individual providers, even those with major capital investment for whom abandonment may be costly, may be forced to choose abandonment rather than remain in the regulated industry." (*Texaco Puerto Rico, Inc. v. Ocasio Rodriguez, supra,* 749 F.Supp. at pp. 372-373.) Of course, government price regulation is valid even if it is arguably "irresponsible." (*Id.* at p. 372.) "[T]he wisdom of . . . *policy* decisions . . . is a matter for the polling place, not the bench." (*Id.* at pp. 372-373, italics in original.)

Turning to the present question, I cannot avoid concluding that *no* insurer, through the operation of Proposi-

tion 103's rate rollback requirement provision, can suffer confiscation under the takings clause of the Fifth Amendment. As explained, "where a service provider voluntarily participates in a price-regulated program or activity, there is no legal compulsion to provide service and thus there can be no taking." (*Garelick v. Sullivan, supra,* 987 F.2d at p. 916.) As also explained, a "service provider" may be said to "voluntarily participat[e] in a price-regulated program or activity" when it has the "right to withdraw" therefrom (*Texaco Puerto Rico, Inc. v. Ocasio Rodriguez, supra,* 749 F.Supp. at p. 372, italics and initial capitalization omitted; accord, *id.* at p. 359.) Insurers are obviously "service providers." Before the passage of Proposition 103, each and every insurer had the "right to withdraw"; after its passage, they continue to have that same right. (See *Travelers Indemnity Co. v. Gillespie* (1990) 50 Cal.3d 82, 92-98, 266 Cal.Rptr. 117, 785 P.2d 500.) "[I]n the normal case the withdrawal process is . . . [nothing] other than simple and expeditious." (*Id.* at p. 92, 266 *Cal.Rptr.* 117, 785 P.2d 500.) In the face of Proposition 103, some insurers chose to exercise their "right to withdraw." (*Id.* at pp. 87-92, 266 Cal.Rptr. 117, 785 P.2d 500.) Others chose not to. (See *ibid.*) The latter thereby voluntarily subjected themselves to Propoistion 103's rate rollback requirement provision. As a result, they could not have suffered confiscation *as a matter of law.* That withdrawal might have been "enormously costly" to them matters not. (*Texaco Puerto Rico v. Ocasio Rodriguez, supra,* 749 F.Supp. at p. 372.) Neither does the "wisdom" of Proposition 103. (*Ibid.*)[1]

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[1] Uniquely to the contrary is the decision in *The Aetna Casualty & Surety Co. v. Commissioner of Insurance* (1970 358 Mass. 272, 281, 263 N.E.2d 698: "[I]nsurers are not required to either submit to confiscatory rates or go out of business." This is "substantive" due process, pure and simple. It has been dead since at least the late 1930's. Indeed, in *Bowles v. Willingham* (1944) 321 U.S. 503, 64 S.Ct. 641, 88 L.Ed. 892, the United States Supreme Court—declaring flatly that "[w]e are not dealing here

For the reasons stated above, I concur in the conclusion that neither Proposition 103's rate rollback requirement provision nor the rate regulations as to rollbacks are facially confiscatory under the takings clause of the Fifth Amendment.

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with a situation which involves a 'taking' of property" (*id.* at p. 517, 64 S.Ct. at p. 648)—validated a certain governmental price regulation that effectively required residential landlords "to either submit to [assertedly] confiscatory rates or go out of business."

APPENDIX B

[Filed Sep. 29, 1994]

IN THE SUPREME COURT OF CALIFORNIA

SO32502

JCCP No. 2419

Super. Ct. L.A. County No. BC046216
[Super. Ct. S.F. County No. 938470]

20TH CENTURY INSURANCE COMPANY *et al.*,
Plaintiffs and Respondents,

v.

JOHN GARAMENDI, as Commissioner, ETC.,
Defendant and Appellant.

Super. Ct. L.A. County No. BS016789

20TH CENTURY INSURANCE COMPANY *et al.*,
Plaintiffs and Respondents,

v.

JOHN GARAMENDI, as Commissioner, ETC.,
Defendant and Appellant,
VOTER REVOLT,
Intervenor and Appellant.

Super. Ct. L.A. County No. BC023983

HARTFORD STEAM BOILER INSPECTION AND INSURANCE COMPANY *et al.*,
Plaintiffs and Respondents.

v.

JOHN GARAMENDI, as Commissioner, ETC.,
Defendant and Appellant.

MODIFICATION OF OPINION

BY THE COURT:

The opinion of the court herein, filed August 18, 1994, and appearing at 8 Cal.4th 216, is modified as follows:

On page 32 of the typed opinion, the last sentence of footnote 5 ("As a stock insurance company, 20th Century is apparently an exception among insurers.") is deleted.

On page 127 of the typed opinion, the fourth sentence ("As a result, the firm apparently experienced a net benefit.") is deleted.

This modification does not affect the judgment.

APPENDIX C

[Filed Feb. 26, 1993]

SUPERIOR COURT
OF THE STATE OF CALIFORNIA
FOR THE COUNTY OF LOS ANGELES

JCCP No. 2419

DECISION AND ORDER ON
SUBMITTED MATTER

COORDINATION PROCEEDING
"PROPOSITION 103 IMPLEMENTATION CASES"

20TH CENTURY INSURANCE COMPANY, *et al.*,

VS.

JOHN GARAMENDI, *et al.*

Case No. SFSC 938470

(Consolidated with BS016789 and BC023983
[as to Leverage Issues])

(BS016789)

20TH CENTURY INSURANCE COMPANY, *et al.*,

VS.

JOHN GARAMENDI, *etc.*

(BC023983)
HARTFORD STEAM BOILER, *et al.*,

VS.

JOHN GARAMENDI, *etc.*

On December 22, 1993, after completion of post trial briefing, this court took under submission both 20th Century's Government Code section 11350 Complaint for Declaratory and Injunctive Relief and its Petition for a Writ of Mandate pursuant to Code of Civil Procedure section 1094.5, as well as its motion pursuant to section 1094.5(e) to Admit Rebuttal Expert Testimony.

The court now renders the following decision.

I. BACKGROUND

On November 8, 1988, California voters adopted the ballot initiative commonly referred to as Proposition 103. Proposition 103 is codified as Insurance Code sections 1861.01-1861.14.[1]

Proposition 103 ("the Proposition") was one of several initiatives on the ballot purporting to solve the California insurance crisis wherein increases in the cost of insurance had made insurance unaffordable and unavailable to many Californians. Its author and sponsor was Voter Revolt.

Regulation of the insurance industry is nothing new. In California, as in other states, various aspects of the insurance industry have been regulated for decades. More than thirty years ago, the United States Supreme Court recognized that there was a "special relationship" between government and the insurance industry justifying more extensive regulation than might be permitted for other industries. *California Automobile Assn v. Maloney* (1951) 341 U.S. 105, 109-110.

In California, the enactment of Proposition 103, however, as the California Supreme Court observed in *Calfarm Insurance Co. v. Deukmejian* (1989) 48 Cal.3d 805, 812 ("*Calfarm*") wrought "fundamental changes in the regulation of automobile and other types of insurance."

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[1] Unless otherwise noted, all references to "sections" are to California Insurance Code.

The divergent views of the Insurance Commissioner and Voter Revolt on the one hand, and of the insurance industry on the other, as to the nature of the fundamental changes and meaning of *Calfarm* has been at the heart of much of the Proposition 103 litigation to date and is very much at the heart of the issues herein.

II. PROPOSITION 103 AND CALFARM

Section 1861.01 provides:

> "(a) For any coverage for a policy for automobile and any other form of insurance subject to this chapter issued or renewed on or after November 8, 1988, every insurer shall reduce its charges to levels which are at least 20% less than the charges for the same coverage which were in effect on November 8, 1987.
>
> (b) Between November 8, 1988, and November 8, 1989, rates and premiums reduced pursuant to subdivision (a) may be only increased if the commissioner finds, after a hearing, that an insurer is substantially threatened with insolvency.
>
> (c) Commencing November 8, 1989, insurance rates subject to this chapter must be approved by the commissioner prior to their use.
>
> (d) For those who apply for an automobile insurance policy for the first time on or after November 8, 1988, the rate shall be 20% less than the rate which was in effect on November 8, 1987, for similarly situated risks.
>
> (e) Any separate affiliate of an insurer, established on or after November 8, 1987, shall be subject to the provisions of this section and shall reduce its charges to levels which are at least 20% less than the insurer's charges in effect on that date."

Section 1861.05 provides:

"(a) No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter. In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company's investment income.

(b) Every insurer which desires to change any rate shall file a complete rate application with the commissioner. A complete rate application shall include all data referred to in Sections 1857.7, 1857.9, 1857.15, and 1864 and such other information as the commissioner may require. The applicant shall have the burden of proving that the requested rate change is justified and meets the requirements of this article.

(c) The commissioner shall notify the public of any application by an insurer for a rate change. The application shall be deemed approved sixty days after public notice unless (1) a consumer or his or her representative requests a hearing within forty-five days of public notice and the commissioner grants the hearing, or determines not to grant the hearing and issues written findings in support of that decision, or (2) the commissioner on his or her own motion determines to hold a hearing, or (3) the proposed rate adjustment exceeds 7% of the then applicable rate for personal lines or 15% for commercial lines, in which case the commissioner must hold a hearing upon a timely request."

Section 1861.08 provides:

"Hearings shall be conducted pursuant to Sections 11500 through 11528 of the Government Code, except that: (a) hearings shall be conducted by administrative law judges for purposes of Sections 11512 and 11517, chosen under Section 11502 or

> appointed by the commissioner; (b) hearings are commenced by a filing of a Notice in lieu of Section 11517(c) and (e) and solely on the basis of the record; (d) Section 11513.5 shall apply to the commissioner; (e) discovery shall be liberally construed and disputes determined by the administrative law judge."

Section 1861.09 provides:

> "Judicial review shall be in accordance with Section 1858.6. For purposes of judicial review, a decision to hold a hearing is not a final order or decision; however, a decision not to hold a hearing is final."

Proposition 103, furthermore, provided for an elected Insurance Commissioner; and, as codified in section 1861.10, it provided for consumer participation in proceedings permitted or established by the Proposition.

Immediately after the adoption of Proposition 103, various insurers petitioned the California Supreme Court to declare the rate rollback and other provisions of Proposition 103 unconstitutional.[2] *Calfarm Insurance Co. v. Deukmejian* (1989) 48 Cal.3d 805.

The insurers contended that the Proposition's rate regulation provisions violated due process clauses of the United States and California constitutions in that the initial reduction to 20% below 1987 levels was arbitrary, discriminatory and confiscatory; the insurers further contended that the rate adjustment mechanism during the first year did not permit relief from confiscatory rates and that adequate procedures were not provided to ensure prompt rate relief. (*Calfarm,* at 814.)

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[2] The Supreme Court also assumed original jurisdiction of the petition for writ of mandamus in *Travellers Indemnity Co. v. Gillespie* (1990) 50 Cal.3d 82, because it raised issues of importance and urgency relating to some of the *Calfarm* issues.

Citing *Permian Basin Area Rate Cases* (1968) 390 U.S. 747 and other cases for the proposition that facial attacks on statutes setting rates are generally rejected, the Supreme Court ruled that section 1861.01(a) was facially constitutional (*Calform*, at 817) because Proposition 103 provided adequate methods for obtaining individualized relief from the rate set by section 1861.-01(a).

The Supreme Court held the insolvency standard, section 1861.01(b), (and one other section not relevant herein) unconstitutional on its face. (*Calfarm*, at 821.)

With respect to section 1861.01(b), the Court first concluded that no definition of insolvency could conform to the constitutional standard of a fair and reasonable return. In this regard, the Court cited, with approval in footnote 9, at page 818, *Power Comm'n v. Hope Gas Co.* (1962) 320 U.S. 591, that "in determining a fair rate of return one must consider 'the financial integrity of the company whose rates are being regulated . . . [I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock [citation]. By that standard the return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.' "

The Court also found that the insolvency standard referred to the insurance company as a whole, not just to regulated lines of insurance. Therefore, the insurer could well be solvent in states other than California, or solvent in lines of insurance in California unregulated by Proposition 103, thus precluding rate relief in California in the lines regulated by Proposition 103. Because of this, the insolvency provision prevented solvent insurers from ob-

taining relief from inadequate rates in California until November 1989. (*Calfarm*, at 819.)

Accordingly, the Court held the insolvency provision invalid under the due process clause of both California and the United States constitutions and ruled that it was also not sustainable as an emergency measure under the law. (*Calfarm*, at 821.)

Having concluded that the insolvency provision was severable and that the voters would prefer rate regulation under the balance of the initiative to no rollback at all, the Court ruled that the "standards set by section 1861.05, subdivision (a), govern rate regulation during the first year of the initiative's operation." (*Calfarm*, 822-823.)

Furthermore, the Supreme Court rejected the insurers' argument that even if section 1861.05 provided a constitutionally valid standard for rate adjustment, they would be compelled to charge confiscatory rates pending administrative relief (pp. 823-825).

The Court stated: "In short, any insurer who believes the rates set by section 1861.01, subdivision (a), are confiscatory may file an application with the Insurance Commissioner for approval of a higher rate. If said application is filed before November 8, 1989, the insurer may immediately begin charging that higher rate pending approval from the Commissioner. After that date, insurance rates subject to Proposition 103 must be approved by the Commissioner prior to their use, but as we have explained, the Commissioner can approve an interim rate pending her final decision." (*Calfarm*, at 825.)

The Court concluded: "In summary, we have concluded (a) that section 1861.01, subdivision (b), limiting first-year rate adjustments to insurers substantially threatened with insolvency is facially invalid, but severable, and does not invalidate the remainder of the initiative; (b) that the procedures for adjustment of insurance rates —including an applicaton to the Commissioner, the op-

portunity to seek interim relief, a hearing in accordance with the Administrative Procedure Act and judicial review —meet constitutional standards; and (c) that in view of the safeguards described in this opinion, the rate rollback and reduction of Proposition 103 is not invalid on its face, but the rates thereby established are necessarily subject to the right of an insurer to demonstrate that a particular rate is, as applied to it, a confiscatory rate." (*Calfarm*, 825-826.)

In its decision, the Court also noted the Commissioner's broad discretion to adopt rules and regulations of general applicability and ability to consolidate cases in order to arrive at an ultimate determination of the rollback obligations in an efficient manner.

If the Commissioner found that the initiative's rate, or some other rate less than the insurer charged, is fair and reasonable, then, the Supreme Court said, the insurer would have to refund excess premiums collected, with interest.

III. ABBREVIATED HISTORY OF PROPOSITION 103 ADMINISTRATIVE PROCEEDINGS AND LITIGATION

Proposition 103 proved to be a problem child from its inception. It is doubtful that any other initiative or legislative enactment has, in a span of just four years, engendered more extensive administrative proceedings and as much litigation as Proposition 103.

It would serve no useful purpose to recount here the complete history of all the administrative and judicial proceedings that have taken place since the passage of Proposition 103 on November 8, 1988; a detailed, though not complete, history can be found in Appendix 1 and Appendix 2 to the Governor's Decision, Cal. Reg. Notice Register 92, No. 9-Z, p. 271, Exhibit E to 20th Century's Request to Take Judicial Notice, filed August 21, 1992; TW 0814-TW 0821. An overview, however, should be helpful in giving context to this litigation.

A. *The Gillespie Era.*

On May 11, 1989, one week after the filing of the *Calfarm* decision, Commissioner Gillespie—the predecessor to the current commissioner, Mr. Garamendi—gave public notice that insurers who wished to do so could file applications for exemption from the rollback provisions of Proposition 103, section 1861.01(a), as modified by *Calfarm*.

Rollback exemption applications were filed by 460 insurers.

As it became apparent that it would be impractical to handle all of the applications individually and that there were a number of generic issues common to all, Commissioner Gillespie, on October 2, 1989, issued an order bifurcating and consolidating the hearings on all pending applications. The first segment of the bifurcated proceeding was to relate to generic issues and the second segment would be company-specific.

After approximately four months of hearings, on June 12, 1990, Commissioner Gillespie issued her decision, setting forth her findings on the generic issues. An amended decision was issued on June 15, 1990, followed shortly by notices to resume company-specific hearings.[3]

The Commissioner's decision was immediately challenged by United Services Automobile Association and a number of other insurers.

This court ruled in USAA v. Gillespie, LASC No. BS 001424, and *SAFECO v. Gillespie*, LASC No. BC 004816 (JCCP No. 2419), that Commissioner Gillespie's June 15, 1990 decision was not final for purposes of judicial review, and that petitioners had special relief available which might moot their complaints, through a variance

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[3] Commissioner Gillespie's generic determinations were adopted as emergency regulations in Title 10, California Code of Regulations, § 2633.1, et seq.

request at the company-specific rollback hearings which the Commissioner was trying to hold and which they were trying to enjoin. This decision was appealed and the appeal dismissed, on grounds of mootness, in the action entitled *SAFECO Insurance Co. v. Gillespie* (Second Division, No. B063893), on December 17, 1992.

Commissioner Gillespie's conscientious and persistent efforts to implement Proposition 103 were also interrupted by considerable other litigation.[4]

Proposition 103's applicability to motorcycle liability insurance was challenged in *Universal Underwriters Insurance Co. v. Gillespie*, LASC BC 013981.

The applicability of Proposition 103 to surety companies and the statutory and constitutional authority of the California legislature to pass Assembly Bill 3798, exempting surety insurance from sections 1861.01 and 1861.05, were raised in *Amwest Surety Insurance Co. v. Pete Wilson, Governor of the State of California, et al.*, LASC No. C 704879, appeal pending, Second Division, No. B058329.

Applicability of section 1861.05(c), the "Deemer provision," to applications for relief from section 1861.01 (a) rollback requirements was decided in *Wilshire Insurance Co., et al. v. Gillespie*, JCCP No. 2419 (LASC nos. BC 004773, BC 004928 and BC 004929), Affirmed, 5 Cal.App.4th 1573 (1992).

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[4] In addition to *Calfarm*, Proposition 103 early on spawned numerous other petitions for writs of mandamus and/or injunctive relief in various counties in the state of California. To avoid duplication of effort, inconsistencies in interpretation of Proposition 103's provisions, and to increase the efficiency of dealing with the litigation, pending Proposition 103 cases were coordinated by order dated February 5, 1990, in Judicial Council Coordination Proceeding, Proposition 103 Implementation Cases, JCCP No. 2419, in the Superior Court for the County of Los Angeles. Over the next four years, numerous cases were added to the JCCP 2419 proceeding and numerous others, presenting narrower or more limited issues, proceeded independently.

Extensive litigation involved the California Automobile Assigned Risk Plan (CAARP) because Propositon 103 did not define the relationship between its provisions and those of the CAARP legislation, Insurance Code sections 11620, et seq. (See *California Automobile Assigned Risk Plan v. Garamendi* (1991) 234 Cal.App.3d 1486 (LASC No. BS 000626); *CAARP v. State of California,* LASC No. C 704876.)

Surplus insurers challenged Commissioner Gillespie's Regulation 2173 and applicability of Proposition 103 to them in *Cowan Surplus Line Insurance Services, Inc. v. Gillespie,* LASC No. BC 010105, and *Kracow v. Gillespie,* LASC No. BC 018284.

Despite constant demands of litigation, Commissioner Gillespie completed two company-specific hearings—as to SAFECO and California State Automobile Association Inter-Insurance Bureau ("CSAA")—in December 1990, before Commissioner Garamendi took office. However, the administrative law judge did not issue his proposed decision until January 7, 1991, the day Commissioner Garamendi assumed his duties.

B. *The Garamendi Era*

Commissioner Garamendi viewed the Gillespie rollback regulations as procedurally and substantively flawed and immediately issued a notice of proposed action expressing his intention to repeal them and replace them with new, permanent regulations, File No. RH-291.

Concurrently, on February 21, 1991, Commissioner Garamendi noticed rate component determination hearings, identified as RCD-1 and RCD-2. The purpose of these proceedings was to develop regulations which would establish rates of return, efficiency standards, levels of executive compensation, premium-to-surplus ratios, and other factors to be applied in determining the insurer rollback obligations.

Eventually, the rate component determinations resulting from these hearings were incorporated into emergency regulations, ER-19a and ER-20.

On January 10, 1992, the Office of Administrative Law (OAL) disapproved the permanent regulations (RH-291) and refused to extend ER-19a emergency regulations. The Commissioner submitted revised emergency regulations as ER-19c and re-adopted ER-20 and ER-20a as emergency regulations.

The saga of the RH-291 proceedings will not be detailed. Suffice it to say that the OAL, acting pursuant to Government Code section 11349.6, ultimately disapproved the RH-291 permanent regulations, except for section 2647.1 dealing with filing fees. The OAL did approve the companion regulations in RH-299.

Commissioner Garamendi's efforts to implement Proposition 103 also were interrupted by litigation challenging his actions.

After the issuance of the RCD-1 and RCD-2 notices, Hartford Steamboilers Inspection Insurance Company (Hartford) and others filed a complaint for injunctive relief and a petition for writ of mandate seeking to enjoin the hearings. *Hartford Steamboilers, et al. v. Garamendi,* LASC No. BC 023983. This court denied the requested relief, holding that Commissioner Garamendi was not precluded from reopening the issues determined in Commissioner Gillespie's June 1990 amended decision.

As noted earlier, SAFECO and CSAA had completed company-specific hearings under the Gillespie regulations. When Commissioner Garamendi proposed to redetermine their rollbacks under his regulations, SAFECO filed an amended complaint for declaratory and injunctive relief, etc., in *General Insurance Co., et al. v. John Garamendi,* LASC No. BC 036620, seeking, among other things, to prohibit the application of the regulations to it in its

company-specific hearing, REB-2123. CSAA sought similar relief in *CSAA v. Garamendi,* LASC No. BC 044991. This court ruled that Commissioner Garamendi's new emergency regulations, ER-19a and ER-20, were applicable to determine CSAA's and SAFECO's rollback obligations.

On December 17, 1992, shortly before this case was taken under submission, the Second District Court of Appeal filed its decisions in *SAFECO v. Gillespie,* Court of Appeal No. B063893, and *State Farm v. Garamendi,* Court of Appeal No. B059086. The Court of Appeal ruled that Commissioner Gillespie's amended decision resulted from a quasi-legislative proceeding because it made generic determinations of general applicability, applicable in future cases, and that Commissioner Garamendi was not bound by such rulemaking but could adopt his own regulations. The Court also noted that the Commissioner's regulations were rate-setting regulations which, pursuant to Government Code section 11346.1(a), need not be approved by OAL, pursuant to Government Code section 11343(a)(1).

The *SAFECO* case involved the nature and finality of Commissioner Gillespie's amended decision, and *State Farm* challenged Commissioner Garamendi's authority to rescind her determinations and adopt new and different regulations. Neither the *scope* of Commissioner Garamendi's authority to adopt the specific regulations, which is at issue here, nor their validity, was at issue in *SAFECO* or *State Farm.* Petitioners in *SAFECO* and *State Farm* have petitioned for review by the Supreme Court.

While Proposition 103 is hardly a model of legislative draftsmanship, its significance cannot be underestimated: it has focused attention on the interests of the consumer, has served as a model for insurance legislation in other states, and has resulted in a number of insurers consenting to substantial rollbacks.

IV. ADMINISTRATIVE AND LITIGATION HISTORY AS TO 20TH CENTURY

20th Century was one of the insurers filing rollback exemption applications pursuant to Commissioner Gillespie's May 11, 1989 notice, *supra,* and also participated in the 1990 Gillespie generic hearings.

20th Century was the first insurer to receive notice for a company-specific hearing based on Commissioner Garamendi's regulations, ER-19a and ER-20, when on October 16, 1991, it was ordered to show cause why it should not be ordered to rollback $85,589,455, plus interest at 10% from May 8, 1989 through the date of payment. The hearing, noticed for December 16, 1991, was denominated File No. REB-5173. (TW 0033-TW 0037.)

20th Century promptly filed a Complaint for Declaratory and Injunctive Relief pursuant to Government Code section 11350, challenging ER-19a and ER-20. *20th Century Insurance Co., et al. v. Garamendi,* SFSC No. 938470.[5] 20th Century challenged the regulations on statutory and constitutional grounds, and for lack of an emergency justifying the Commissioner's resort to the emergency regulation process of Government Code section 11346.1. This court found that Commissioner Garamendi's determination of emergency was proper, and that 20th Century had not exhausted its administrative remedies and could not raise the other issues until the pending company-specific hearing was completed.

REB-5173 was completed in March 1992, and the Administrative Law Judge ("ALJ") rendered her proposed decision requiring 20th Century to rollback $78 million, plus interest at 10% from May 8, 1989, effective 20 days thereafter, pursuant to Insurance Code section 1858.6. (TW 2748-TW 2947.) The Commissioner adopted the proposed decision on May 8, 1992. (TW 2949.)

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[5] This action was "added-on" to JCCP 2419 and will be referred to herein as 20th Century I.

20th Century filed a Petition for Writ of Mandate, pursuant to Code of Civil Procedure section 1094.5, *20th Century v. Garamendi*, LASC No. BS 016789 ("20th Century II"), seeking to set aside the May 8, 1992 order and to invalidate ER-19c and ER-20a.

On June 12, 1992, 20th Century filed its First Amended Complaint for Declaratory and Injunctive Relief in 20th Century I challenging, among other things, ER-19c and ER-20a, RH-291 and RH-299, and the Commissioner's authority to implement Proposition 103 by such regulations.

V. PARTIES AND PROCEDURAL STATE OF THIS CASE

On July 6, 1992, this court ordered the consolidation of 20th Century II with the coordinated action, 20th Century I.

Prior to the consolidation, Allstate Insurance Company and Voter Revolt were allowed to file complaints-in-intervention in 20th Century II.

To provide a more efficient and expeditious disposition of the Proposition 103 coordinated cases, this court also granted Hartford's motion to bifurcate and consolidate *Hartford Steamboilers v. Garamendi*, BC 023983, as to certain issues which did not require the filing of additional administrative record and any significant expansion of the 20th Century litigation.

American Insurance Association ("AIA"), California Casualty and California State Automobile Association Insurance Bureau ("CSAA"), State Farm Insurance Companies, and the Hartford parties as to issues not consolidated, were allowed to file amicus curiae briefs.

As noted earlier, OAL disapproved the RH-291 permanent regulations and the emergency regulations have now expired. Thus, no regulations are currently in effect, un-

less footnote 8 in *SAFECO, supra,* is dispositive of this issue. This court, of course, must follow precedential rulings of higher courts. However, in response to possible argument that footnote 8 is only dictum, this court will proceed to rule on the issue of mootness as presented by the parties.

In its brief, amicus curiae CSAA contends that if the regulations are not in effect at the time of this court's ruling in this case, that the court must vacate the rollback order issued to 20th Century in REB-5173 and remand the matter to the Department of Insurance for further proceedings and dismiss as moot the facial challenges to the regulations made by 20th Century and the Hartford plaintiffs.

20th Century objects to this court reaching the merits of the administrative order unless the Commissioner stipulates that if new, more favorable regulations are adopted, 20th Century would be given a new hearing and new determination of its rollback liability (fn. # 3, 20th Century's Reply to Commissioner's Opposition to Motion for Summary Judgment, etc.; fn. # 1, 20th Century's Reply to Commissioner's Main Opposition Brief).

This court finds that even if OAL's approval of the regulations is required, the issues herein are not mooted by OAL's disapproval of the RH-291 regulations. The 20th Century company-specific hearing was completed while the emergency regulations were in effect and before the RH-291 regulations were disapproved. A rollback order was issued pursuant thereto. 20th Century has challenged that rollback order. This case now presents the issues going to the heart of Proposition 103 in a posture contemplated by *Calfarm.* The mootness doctrine is not applicable on the facts herein as to 20th Century.

VI. ISSUES PRESENTED AND RELIEF SOUGHT

The First Amended Complaint for Declaratory and Injunctive Relief (Government Code section 11350) presents a facial attack on ER-19c, ER-20a, RH-291 and RH-299 as follows:

(1) Are the regulations which set up a rate-of-return regulation system common to public utilities inconsistent with the provisions of Proposition 103 and its declared purpose and beyond the Commissioner's lawful authority?

(2) Are the regulations and, more specifically, the formula, establishing "minimum constitutional" rates for the rollback year impermissible under the "excessive, inadequate" standard mandated by section 1861.05(a) and held applicable to rollbacks by *Calfarm*?

(3) Do the regulations restrict evidence presented in company-specific hearings in a manner inconsistent with section 1861.08 and *Calfarm*?

(4) Is the imposition of the 10% interest rate from May 8, 1989, to date of payment contrary to law?

(5) If rate-of-return regulation was authorized, is the 10% rate of return supported by evidence in the RCD-2 administrative record?

(6) If the regulations are held to be authorized by, and consistent with, Proposition 103, is Proposition 103 constitutional on its face and as applied to 20th Century?

20th Century's Petition for Writ of Mandate (CCP section 1094.5), (20th Century II), attacks the 170 findings of the ALJ and her decision on procedural and substantive grounds and on both statutory and constitutional grounds. The issues generally parallel those in 20th Century I, but in an "as applied" context. 20th Century contends:

(1) That, contrary to section 1861.05 and *Calfarm*, it was precluded from offering evidence that its rates were

not excessive, inadequate, or unfairly discriminatory because the regulations impose different standards and procedures;

(2) That the regulations calculate rollbacks through formulas which allow rates in many lines of insurance at levels lower than the 20% below 1987 rates provided for in section 1861.01(a) and result in cross-subsidization in violation of section 1861.05(a);

(3) That the administrative law judge's decision is invalid because it is based on regulations that regulate rates of return, contrary to, and in excess of, authority granted in Proposition 103;

(4) That the regulations do not allow an adequate rate in low-frequency, high-severity lines such as earthquake, contrary to statutory authorization, and that as a result of such disallowance, unrelated to whether the expense is prudent, 20th Century is precluded from recovering even the 10% rate of return provided for in the regulations. 20th Century complains that cost of reinsurance is not even recognized as an expense for either ratemaking purposes or determining recoverable costs;

(5) With respect to the 10% rate of return allowed by regulations, the rate was unsupported by evidence in the administrative record (RCD-2) and as applied to it. In this regard, 20th Century complains that certain of its evidence was rejected and that the Commissioner, instead of applying the well-established test of confiscation set forth in *Calfarm,* held that 20th Century had failed to show "deep financial hardship," resulting, in effect, in the reinstitution of the insolvency standard, which the Supreme Court invalidated in *Calfarm*;

(6) That its company-specific hearing lacked fundamental fairness because of the expedited schedule, limitations on evidence, improper and shifting rules and standards, order of proof, refusal to permit some witnesses to

present oral testimony or provide rebuttal testimony, and reliance on material outside the record, all of which deprived 20th Century of its statutory and constitutional rights to a fair adjudicatory hearing.

20th Century's attack on specific findings falls generally within one of the above categories, and no purpose would be served by reiterating all of the errors specified at pages 10 through 19 of the petition.

By way of summary, 20th Century attacks the application of "deficiency standards" and the formula for computing fixed expenses on the grounds that they disallow prudent and reasonably incurred expenses without any showing that such expenses are in any way improper, unreasonable, or imprudent (pages 12-13); that the method of calculating allowable fixed expense yields an inadequate rate as to low-frequency, high-severity lines (such as earthquake) unless the insurer has sustained severe losses in 1989 (page 13); that the formula unfairly and unconstitutionally fails to account for the cost or expense of insurance in lines such as earthquake, resulting in the arbitrary and capricious denial of an adequate rate for such lines of insurance (page 13); that failure to use the normative leverage factors fails to account for 20th Century's greater risks and its resulting higher cost of capital, as contemplated by *Calfarm* (pages 13-14); that even if the constitutional standard were to be applied rather than the statutory standard, determining a fair rate of return depends on identifying for each insurer its cost of capital and allowing it to earn a rate of return earned by investments of comparable risk, rather than set according to any industry-wide, historical experience (page 14); that 20th Century is entitled to a variance if it proves that its rate satisfied the "excessive, inadequate" standard or its cost of capital is greater than that allowed by the regulatory formula (pages 14-15); and that 20th Century was precluded from establishing that its rate was fair and the 10% rate inadequate as to it, by various rulings exclud-

ing its evidence, contrary to Proposition 103 and in violation of its constitutional rights.

Additionally, the *Hartford* issue consolidated herein was whether the regulations and formula disregard a portion of the insurer's capital, and thereby deny a fair and reasonable return.

In 20th Century I, 20th Century seeks a judgment declaring: that the Commissioner has no authority under Proposition 103 to regulate the rates of return earned by insurers; that the Commissioner must review all rate filings submitted under the excessive/inadequate standard of section 1861.05; that the insurers at the company-specific hearings are entitled to introduce all evidence relevant to the statutory standard and cannot be limited to introducing only evidence pertaining to the three variances specified in the regulations; that an interest rate in excess of 7% from May 8, 1989 is contrary to law and unauthorized; that ER-19c and ER-20a and RH-291 and RH-299 were issued and promulgated in excess of the Commissioner's lawful authority; that the 10% rate of return allowed is not supported by the administrative record RCD-2; that the regulations are null and void; and that the Commissioner be enjoined from enforcing the regulations or any administrative orders made pursuant to them.

In 20th Century II, 20th Century seeks a writ of mandate directing and compelling the Commissioner: to set aside the May 8, 1992 order directing 20th Century to refund 12.203% of premium (approximately $78 million to policyholders; to rescind ER-19c and ER-20a, to conduct an administrative hearing pursuant to section 1861.08 to determine 20th Century's rollback obligation; to declare that the statutory standard governing rollbacks is the excessive/inadequate standard of section 1861.05 (a) and the Commissioner is not authorized to regulate rates of return; to declare that costs and expenses reasonably incurred by 20th Century during the rollback period

such as reinsurance premiums were reasonably incurred and must be allowed as legitimate and prudent expenses in the determinaton of 20th Century's rollback liability; that the 10% rate of return is unconstitutional on its face and as applied; to command the Commissioner and the ALJ to admit into evidence all testimony and exhibits excluded in the hearing, and to give 20th Century adequate time to prepare for hearing.

Because every issue raised revolves around the regulations, a summary of all the regulations relevant herein is useful before embarking on discussing and ruling on the issues.

VII. THE RATE REGULATIONS

The rate regulations to implement Proposition 103 developed by Commissioner Garamendi, and challenged herein as to rollbacks, are codified at Cal. Code of Regs., Title 10, chapter 5, subchapter 4.8, articles 1-7, sections 2641.1 through 2647.1.[6]

The regulations for determination of rates for the *rollback* period are contained in article 5, section 2645.1 through section 2645.9.

Section 2645.3 provides that except as otherwise specified in article 5, rates for the rollback period shall be evaluated as specified in article 4.

The heart of rate-setting under both articles 4 and 5 is the mathematical formula codified in article 4 at sections 2644.2 and 2644.3.

This basic ratemaking formula, provided to determine the maximum/minimum earned premium ("EP"), is stated as follows:

$$\textit{Max/min permitted EP} = \frac{\textit{losses} + \textit{ALAE} + \textit{fixed expenses-ancil income}}{\textit{1-var exp factor-profit factor-invest inc factor}}$$

[6] These regulations will be referred to hereafter by their section numbers only.

Pursuant to section 2645.3(a), to the extent the rates actually charged during the rollback period exceeded the minimum permitted EP, the excess shall be refunded to consumers.

The formula is complex. While the numerator of the fraction is expressed in dollars, the denominator consists of ratios. The components of the numerator, as well as those of the denominator, are defined in the regulations. The interrelationships are multilayered. Components of the formula are themselves determined by separate formulas. For example, one of the components of the numerator—fixed expenses—must be determined by a formula which includes some of the components of the denominator. The formula is, as the Commissioner described it, "recursive."

A. The Numerator

1. *Ancillary Income.* Ancillary income (sometimes referred to as "other income") is non-premium revenue received incidentally to the insurance transaction, such as fees and interest charged by the insurer that is financing the consumer's premium. The amount of ancillary income is taken directly from the insurer's reported operating results. (§ 2644.13.)

2. *Losses.* Section 2645.4 provides that "in lieu of projected losses," which are defined in sections 2644.4-2644.7, "actual loss and loss adjustment data for calendar year 1989 shall be used." It further provides for adjustments in certain circumstances.

3. *Allocated Loss Adjustment Expenses (ALAE).* Loss adjustment expenses are the costs of processing claims, or adjusting losses. The industry distinguishes between allocated and unallocated loss adjustment expenses. Allocated loss adjustment expenses are costs allocable to a particular loss and typically represent claim-defense costs (e.g., defense counsel fees). Unallocated

loss adjustment expenses customarily are the costs incurred in adjusting claims generally, such as salaries and overhead of the claims department.

Section 2645.4 provides for use of actual loss adjustment data for 1989, again subject to adjustments in certain circumstances.

4. *Fixed Expenses.* These costs, typically thought of as the insurer's "overhead," are set forth in section 2644.9. They include the unallocated loss adjustment expenses, "general" expenses (e.g., management salaries, office rent), "other acquisition" (sales costs other than agent and broker commissions, such as advertising), and taxes and fees other than federal income tax and state premium taxes.

Excluded from fixed expenses, pursuant to section 2644.10, are certain categories of expenses, such as political contributions and lobbying, executive compensation determined to be excessive by the Commissioner under section 2646.3, bad faith judgments, fines and penalties, and institutional advertising expenses.

Furthermore, the fixed expenses are limited by the efficiency standard set forth in section 2644.12. This formula is stated as follows:

$$\textit{Max fixed exp} = \frac{\textit{(losses + ALAE + ancil income)}\ \textit{(effic std-var exp factor)}}{\textit{1-profit factor + invest inc factor-effic std}}$$

As to rollback determinations, section 2645.5(a) specifies formulas for the maximum permissible executive salaries which may be included in fixed expenses, and section 2645.5(b) provides that fixed expenses for each line shall be set at the lower of the quantity specified in section 2644.12(a) or actual recorded expenses for 1989.

Section 2645.5(b) further provides that for rollback calculations, "maximum profit factor" in section 2644.12 means "profit factor" as defined in section 2645.6.

Section 2645.6(a) provides: "The after-tax rate of return for property and casualty insurance, corresponding to the lower boundary of the range of reasonable returns, is 10.0 percent."

Subdivision (c) of section 2645.5 contains a table of percentages for determining the applicable efficiency standard for rollback calculations.

B. The Denominator

1. *Variable Expense Factor.* Section 2644.14 defines this factor as "the sum of the commission rate and the state premium tax rate." The operation of the formula excludes part of the commissions and premium taxes actually paid in 1989.

2. *Profit Factor.* Section 2644.15 (section 2645.6 for rollbacks) defines the profit factor as follows:[7]

Maximum permitted after-tax rate of return (i.e., for rollbacks, it is 10% pursuant to section 2645.6(a)), divided by the product of the "leverage factor" [8] (i.e., for rollbacks, as specified by the Commissioner, pursuant to section 2645.6(b)), multiplied by the insurer's federal income tax factor, defined in section 2644.18 (i.e., 1.0 minus the insurer's 1989 effective federal income tax rate, expressed as a percent of pre-tax net income).

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[7] Section 2643.5 provides that statutory accounting principles (SAP) shall be used to measure equity, rather than generally-accepted accounting principles (GAAP).

[8] Section 2644.17(a) states that "leverage factor" means ratio of net written premiums to surplus. Section 2644.17(b) provides: "The Commissioner shall, from time to time, establish, in accordance with section 2646.3 [generic determinations], industry-wide leverage factors for each insurance line. Each insurer's surplus shall be allocated to its respective lines in proportion to the industry-wide reserves. In determining the leverage ratios, the Commissioner shall give due consideration to regulatory standards of insolvency and actual industry-wide, all-lines ratio of net written premiums to surplus."

For the rollback period, section 2645.6(b) provides leverage ratios for 18 specified lines. The regulation further provides that, if the insurer operated with less surplus than the leverage factors adopted by the commissioner, the insurer's actual leverage ratio shall be used. The insurers must thus use the higher of their actual leverage or the imputed leverage. Furthermore, "[t]he insurer's actual leverage ratio shall be computed by allocating [its] surplus to lines in proportion to the insurer's average 1989 reserves as specified in section 2644.21 [reserves ratio]." (§ 2645.6, subd. (c).)

For the adjustment for federal income taxes, section 2644.18(a) specifies that the insurer's actual effective tax rate (of 1989 for rollback calculations) is used, "giving full account to all tax credits and offsets used or available to the insurer."

These operations, which are combined to produce the profit factor in the denominator of the ratemaking formula, can be represented as follows:

$$\textit{Profit factor} = \left(\frac{10\%}{\textit{leverage factor (1-income tax rate as specified at 2644.18)}} \right)$$

3. *Investment Income Factor.* The investment income factor in the denominator of the ratemaking formula is defined and stated as a formula, as follows:

$$\textit{Invest inc factor} = (\textit{yield}) \left(\frac{\textit{average reserves}}{\textit{earned premium}} + \frac{\textit{surplus}}{\textit{net written premium}} \right)$$

(§§ 2644.19, 2644.20, 2644.21, 2644.22, 2645.8.)

For the rollback period, section 2645.8 provides that "[t]he insurer's imbedded yield, plus the five-year average (1985 through 1989) of realized capital gains" shall be used. Furthermore,

> Imbedded yield shall be calculated as the insurer's net investment income, excluding capital gains, divided by the average of the insurer's year-end surplus and reserves for 1988 and 1989. The insurer's five-year average realized capital gains shall be calculated

> as the mean of the quotients, for each year 1985 through 1989, of the annual realized capital gains and the average of the insurer's year-end surplus and reserves for that year and the previous year.

As set forth in the formula, *supra*, the yield is then multiplied by two fractions. The first is the reserves ratio, representing "the average of the last two years . . . loss reserves, plus . . . unearned premium reserves . . . divided by the earned premium for the most recent year for which data are available." (§ 2644.21); the second is the surplus ratio, defined as "the reciprocal of the leverage factor." (§ 2644.22.)

C. Procedure for Rate Determination

Article 6, comprising sections 2646.1 through 2646.5, provides for the procedures and rights in the determination of rates.

Hearings. Of special importance here is section 2646.4, "Hearings on Individual Insurers' Rates."

Subdivision (b) of Section 2646.4 provides:

> (b) A hearing on a rate application, and a hearing based on the allegation that a rate in effect is excessive, inadequate, unfairly discriminatory or otherwise in violation of chapter 9 (commencing with section 1851) of part 2 of division 1 of the Insurance Code shall be for the purpose of determining whether
>
> (1) the insurer has properly applied the statute, these regulations, and the generic determinations made pursuant to these regulations in calculating the maximum or minimum permitted earned premium; or
>
> (2) the maximum permitted earned premium or minimum permitted earned premium calculated on the basis of the statute, these regulations, and the generic determinations made pursuant to these regu-

lations should be adjusted as provided in subdivision (c) of this section. A request that the maximum permitted earned premium or minimum permitted earned premium should be adjusted is referred to as a "variance request."

Subdivision (c) of section 2646.4 provides eight (8) "valid bases for requesting a variance" of a rate. The three grounds for a variance applicable to an insurer's rollback obligation, pursuant to section 2646.4(d), are the following:

(c)(4) That the insurer should be authorized a rate of return different from the rate of return determined pursuant to section 2644.16 on the ground that the insurer writes in only one line and its mix of business presents investment risks different from the risks that are typical of the line as a whole.

(c)(5) That the insurer should be granted relief from operation of the efficiency standard for a line of insurance in which the insurer has never previously written over $1 million in earned premiums annually and in which the insurer has made or is making a substantial investment in order to enter the market.

(c)(8) That the insurer's financial condition is such that its maximum permitted earned premium should be increased in order to protect the insurer's solvency.

Moreover, subdivision (e) of section 2646.6 provides:

(e) Relitigation in a hearing on an individual insurer's rates of a matter already determined either by these regulations or by a generic determination is out of order and shall not be permitted. However, the administrative law judge shall admit evidence he or she finds relevant to the determination of whether the rate is excessive or inadequate (or, in the case of a proceeding under Article 5, relevant to the de-

termination of the minimum nonconfiscatory rate), whether or not such evidence is expressly contemplated by these regulations, provided the evidence is not offered for the purpose of relitigating a matter already determined by these regulations or by a generic determination.

Generic Determinations. Generic determinations are defined, and procedures for making them are specified, in section 2646.3. Section 2646.3, among other things, provides that a generic determination is a finding by the Commissioner, "intended to apply to the rate applications of several or all insurers" (subd.(a)), and that the "determination shall be made in a consolidated hearing. . . . All affected insurers . . . shall be entitled to become parties. . . . The generic determination shall be adopted as a regulation pursuant to . . . [Gov. Code §§ 11340-11356] . . . and shall be binding in hearings on individual insurers' rates" (subd.(b)).

Section 2646.3 is specifically referenced throughout the regulations in approximately twelve (12) of the sections. In particular, the regulations provide that "[t]he Commissioner shall, from time to time, determine," under section 2646.3, "the maximum and minimum permitted after-tax rate of return for property and casualty insurance ratemaking" (§ 2644.16, Rate of Return), "industry-wide leverage factors for each insurance line" (§ 2644.17, Leverage Factor and Surplus), and to "specify credibility criteria and appropriate sources of substitute data" regarding "permitted earned premiums [that] are based upon data that lack credibility" (§ 2644.23, Credibility Adjustment).

Moreover, under section 2646.3, the Commissioner is required to adopt certain other components and subcomponents of the formula, such as the efficiency standard of section 2644.12(b), "the expense trend factor by which allowable historic fixed expenses shall be multiplied"

(§ 2644.11, Expense Trend), "executive compensation that exceeds [a] reasonable amount" (§ 2644.10, Excluded Expenses), loss trend factors (§ 2644.7, Loss Trend), the number of "reporting intervals . . . for a given line" to determine "which reported losses are adjusted for anticipated payout patterns" (§ 2644.6, Loss Development), and the number of years in a catastrophic loss adjustment formula (§ 2644.5, Catastrophe Adjustment).

VIII. THE STANDARD OF REVIEW

Proposition 103, at section 1861.09, provides that "[j]udicial review shall be in accordance with [s]ection 1858.6." As relevant, section 1858.6, provides:

> *Any finding, determination, rule, ruling or order* made by the commissioner under this chapter shall be subject to review by the courts of the State and proceedings on review shall be in accordance with the provisions of the Code of Civil Procedure. *In such proceedings on review, the court is authorized and directed to exercise its independent judgment on the evidence* and unless the weight of the evidence supports the findings, determination, rule, ruling or order of the commissioner, the same shall be annulled.

The parties agree that the Commissioner's REB-5173 determinations are subject to review under the independent judgment scope of review set forth in section 1858.6.

The "weight of the evidence" standard applicable pursuant to section 1858.6 is the same as the "preponderance of the evidence" standard of Evidence Code section 115, and the court must weigh the evidence as it would in a trial. (*Chamberlain v. Ventura County Civil Service Commission* (1977) 69 Cal.App.3d 363, 368.) The fact that the Commissioner may have resolved a conflict in the evidence in one way does not bind the court in its review of the evidence under the independent judgment standard.

(*Pittsburgh Unified School Dist. v. Commission on Professional Competence* (1983) 146 Cal.App.3d 964, 976.) The findings of the Commissioner, however, come before the court with a strong presumption of correctness and 20th Century has the burden of convincing the court that the Commissioner's decision is contrary to the weight of the evidence. (*Chamberlain, supra*, at 368, 371 [citing *Drummey v. State Board, etc.*, 13 Cal.2d 75; 85].)

The parties disagree as to the standard of review applicable to the Commissioner's rate regulations and his authority to promulgate them.

The insurers[9] argue that the independent judgment standard applies to the regulations as well. They point to Proposition 103 section 1861.09 expressly incorporating section 1858.6 and to the legislative history of the McBride-Grunsky Insurance Regulatory Act of 1947. They also note that Government Code section 11342(b) defines "regulation" as encompassing "[e]very rule, regulation, order, or standard of general application. . . ."

The Commissioner, on the other hand, urges that "judicial review" in section 1861.09 applies only to determinations made in adjudicatory hearings held pursuant to section 1861.08,[10] and that section 1861.08 does not apply to rulemaking or generic determinations adopted pursuant to the Commissioner's implied powers. These, the Com-

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[9] Unless clear from the context or expressly indicated otherwise, "20th Century" and "insurers" are used interchangeably in this decision because the contentions of intervenor Allstate, the insurer amici and 20th Century do not differ materially on the issues herein and 20th Century has expressly incorporated most of their arguments. Similarly, because the positions of intervenor Voter Revolt and of the Commissioner do not diverge on most issues, reference will generally be made to "Commissioner" simply for the sake of brevity.

[10] The insurers also contend that the section 1861.08 requirement for adjudicatory hearings on rate applications precludes the regulations at issue herein.

missioner contends, are subject to review only under the arbitrary/capricious standard. The Commissioner also contends that the same narrow review applies to his determinations that the rollback regulations are consistent with, and authorized by, Proposition 103, as modified by *Calfarm*.

This court concludes that section 1858.6, independent judgment scope of review, does not apply to the regulations, which are within the Commissioner's authority to adopt.[11]

This court is unable to discern any voter intent with respect to Proposition 103 section 1861.09 incorporating section 1858.6; to do so would be mere speculation. However, the most reasonable construction of section 1861.09 is that it applies only to determinations made in adjudicatory hearings held pursuant to section 1861.08, and that regulations, to the extent authorized by Proposition 103 and *Calfarm*, are reviewable under law generally applicable to review of regulations. That section 1861.09 in its text refers specifically to "hearings" and makes no reference to regulations further supports this construction.

Furthermore, section 1858.6 requires independent judgment review of "rules." Does "rules" in section 1858.6 include "regulations"? This court concludes that it does not.

The argument that the Government Code definition of "regulation" includes "rule" is not persuasive in view of the Insurance Code referring to both in various places. (See Hartford Reply Memo, page 3). Thus, it appears that omission of "regulations" from section 1858.6 was

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[11] **Whether the regulations resulted from RCD proceedings or general rulemaking is irrelevant. *State Farm* and *SAFECO* held that all proceedings leading to generic determinations of general applicability, applicable in future cases are quasi-legislative. It follows logically, then, that they are subject to the same review as regulations.**

deliberate. This conclusion is further supported by the fact that the McBride-Grunsky Act clearly did not contemplate adoption of rate regulations, but was concerned with rating plans and underwriting rules utilized under the "open competition" system. As rulemaking generally involves questions of policy and/or highly technical and often complex matters requiring special expertise, courts have held that broad discretion is given to the expert agencies charged with the duty of adopting regulations, and scope of judicial review of such regulations is limited. Section 1858.6 on its face, nor its legislative history, indicate that this well-established principle was being abrogated.

A recent succinct statement of the scope of review of administrative regulations is found in *Calif. Assoc. of Psychology v. Rank* (1990) 51 Cal.3d 1, as follows:

> When a court inquires into the validity of an administrative regulation to determine whether its adoption was an abuse of discretion, the scope of review is limited. As we said in *Pitts v. Perluss* (1962) 58 Cal.2d 824, "[a]s to quasi-legislative acts of administrative agencies, 'judicial review is limited to an examination of the proceedings before the officer to determine whether his action has been arbitrary, capricious, or entirely lacking in evidentiary support, or whether he has failed to follow the procedure and give the notices required by law.' " (P. 833; see *Culligan Water Conditioning v. State Board of Equalization* (1976) 17 Cal.3d 86, 92-93.)[5] When, however, a regulation is challenged as inconsistent with the terms or intent of the authorizing statute, the standard of review is different, because the courts are the ultimate arbiters of the construction of a statute. Thus, *Morris v. Williams* (1967) 67 Cal.2d 733, in finding that the challenged regulations contravened legislative intent, rejected the agency's claim that the only issue for review was

> whether the regulations were arbitrary or capricious. Our opinion explained that "[w]hile the construction of a statute by officials charged with its administration . . . is entitled to great weight,' nevertheless, '[w]hatever the force of administrative construction . . . final responsibility for the interpretation of the law rests with the courts.' [Citation.] Administrative regulations that alter or amend the statute or enlarge or impair its scope are void and courts not only may, but it is their obligation to strike down such regulations." (P. 748; see *Dyna-Med Inc. v. Fair Employment & Housing Comm.* (1987) 43 Cal.3d 1379, 1388-1389; *Hittle v. Santa Barbara County Employees Retirement Assn.* (1985) 39 Cal.3d 374, 387.) Although in determining whether the regulations are reasonably necessary to effectuate the statutory purpose we will not intervene in the absence of an arbitrary or capricious decision, "we need not make such a determination if the regulations transgress statutory power. (67 Cal.2d at p. 749.)

Earlier, in *Assn. for Retarded Citizens v. Dept. of Dev.* (1985) 38 Cal.3d 384, 390-91, the Supreme Court stated:

> The scope of judicial review of quasi-legislative administrative action is well-settled. To be valid, such administrative action must be within the scope of authority conferred by the enabling statute. We have long recognized, of course, that the construction of a statute by officials charged with its administration, including their interpretation of the authority vested in them is entitled to great weight. Nevertheless, whatever the force of administrative construction, final responsibility for the interpretation of the law rests with the courts.

The Insurance Commissioner is a creature of statute with only the powers delineated therein. *Blood Service Plan Ins. Co. v. Roddis* (1968) 259 Cal.App.2d 807,

811. His power is limited to those powers expressly conferred by Proposition 103, as modified by *Calfarm*, and those "additional powers" that are "necessary for the due and efficient administration of powers expressly granted" by the statute. See *Calfarm*, 258 Cal.Rptr., at 172. Pursuant to Government Code section 11342.2, a regulation cannot be "valid and effective unless consistent and not in conflict with the statute."

As set forth in the *Roddis* case, while the Commissioner's construction of a statute that he is charged with administering is entitled to great weight, final responsibility for the interpretation of the law rests with the courts. It is ultimately for the courts to decide whether regulations are statutorily authorized and whether they alter, impair, or amend the scope of a statute. Furthermore, with respect to interpretation of *Calfarm*, the Commissioner's insurance expertise gives him no advantage over the courts. This court, of course, is bound to follow *Calfarm*.

Regulations found to be within the authority afforded to the Commissioner by Proposition 103 as modified by *Calfarm*, regardless of the procedure by which they were adopted, are reviewable under the arbitrary/capricious standard described in *Rank, supra*.

IX. THE COMMISSIONER'S STATUTORY AUTHORITY TO PROMULGATE THE RATE REGULATIONS

In promulgating his rollback regulations, Commissioner Garamendi relied primarily on sections 1861.01 and 1861.05 and *Calfarm* as the sources of the regulatory power for the adoption of his regulations.[12]

In interpreting an initiative statute, such as Proposition 103, the court must consider the language of the initiative

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[12] Sections 2643.4, 2645.9 and 2647.1 cite to other statutory provisions as authority, as well as Ins. Code §§ 1861.01 and 1861.05.

itself, the ballot materials, and the purpose of the initiative. In *AIU Insurance Company v. Gillespie* (1990) 222 Cal.App.3d 1155, 1159, the Court, citing *Kaiser v. Hopkins* (1936) 6 Cal.2d 537, 538, and *Diamond International Corporation v. Boas* (1979) 92 Cal.App.3d 1015, 1034, observed that the goal was giving effect to the intent of the voters. In achieving this goal, "the words must be read in a sense which harmonizes with the subject-matter and the general purpose and object of the amendment, consistent of course with the language itself. . . . They are to be understood in the common popular way, and, in the absence of some strong and convincing reason to the contrary, . . . they are not entitled to be considered in a technical sense inconsistent with their popular meaning. . . . [Citations.]" (See also *Ikerd v. Merrill & Sons* (1992) 9 Cal.App.4th 1833, fn. 9.)

The purpose of Proposition 103 is set forth in section 2 of the initiative measure. It is to "protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." (See Historical and Statutory Notes, 42A West's Ann. Ins. Code (1993 Supp.) § 1861.01, p. 105.)

It is clear from the language of 1861.01(a) that the voters immediately wanted at least a 20% rollback from 1987 rates. The only limitation on rollback liability was substantial threat of insolvency.[13]

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[13] Pursuant to section 1861.01(c), the voters also wanted prior approval of future rate increases.

It may be noted that historically, in most states, insurance rates have been determined by open competition, "file and use" system, or a "prior approval" system. Statutes in a few states provide for "state made" rates, where the regulator sets the rates. In open competition, the insurer can charge whatever it wants and need justify the rate only if requested by the regulator. In "file and use", the rate is filed with the regulator before effective date and becomes effective unless the regulator takes affirmative action to

However, nowhere in Proposition 103 did the voters *expressly* authorize the Insurance Commissioner to adopt substantive regulations for the determination of the insurer rollback liability, or to engage in ratemaking.

In contrast to subdivisions (a)(4) and (e) of section 1861.02, section 1861.025(4), section 1861.055, and section 1861.10(c)(2) (in all of which the voters expressly provided for the adoption of regulations by the Commissioner), neither section 1861.01 nor section 1861.05 expressly authorizes the Commissioner to adopt regulations to implement them. Instead, the voters, in section 1861.05 and 1861.01(b) (invalidated by *Calfarm*), provided for hearings with respect to rate applications filed pursuant to said sections.

The express language of Proposition 103, thus, shows no voter intent to empower the Commissioner to adopt substantive rollback regulations, much less make a rollback rate of his own.[14]

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disapprove. In "prior approval", rates must be filed with the regulator before the effective date and are not effective unless approved by the regulator or deemed approved where a regulator doesn't act within the statutory period.

Proposition 103 made California a prior approval state. (See section 1861.01(c); and see section 1 of the Initiative Measure providing that insurers must justify future increases.) Furthermore, the Legislative Analyst's ballot pamphlet for Proposition 103 explained that "currently, the Department of Insurance does not review and approve insurance rate changes before they take effect", but that Proposition 103 "requires the Insurance Commissioner to review and approve rate increases . . . before they take effect." Voter Revolt, the authors of Proposition 103, apparently presented this same interpretation to the Supreme Court in *Calfarm* (Brief of amicus American Insurance Association, at p. 8), and the Supreme Court accepted it. (*Calfarm*, at p. 825, fn. 17.)

[14] Regulations which exceed the scope of the enabling statute are invalid. (See Gov. Code, § 11342.2; *Wildlife Alive v. Chickering*, (1978) 18 Cal.3d 190, 205; *Credit Insurance General Agents Assn v. Payne* (1976) 16 Cal.3d 651, 656.) In *Credit Insurance*, the court held that "absence of any specific provision regarding regula-

Furthermore, it is questionable whether, prior to *Calfarm* invalidating section 1861.01(b) and incorporating the 1861.05 standards, section 1861.01 provided *implied* authority for adoption of regulations such as the formula and its components.

The Commissioner may have had implied power under section 1861.01(b) to promulgate regulations specifying which of several recognized insolvency standards or definitions would be applied in determining the insurer's rollback obligations (see *Calfarm*); but, because all these insolvency standards look to the actual financial condition of a particular business enterprise, regulations based on historical, industry-wide, nationwide, or average criteria or formulas—which do not focus on the individual insurer's actual financial condition during the rollback year—would have been in excess of or inconsistent with section 1861.01, and therefore, would have altered the scope of that section. The Supreme Court in *Calfarm,* at page 819, footnote 11, specifically noted the Commissioner's limited discretion in making the "substantially threatened with insolvency" determination, when it said that the Commissioner would have been precluded from setting a constitutional rate above the insolvency standard.

Thus, no voter intent to authorize full-blown regulatory ratemaking can be discerned from Proposition 103 itself.

Furthermore, there is nothing in the Proposition 103 ballot argument from which a voter could reasonably conclude that he/she was voting for ratemaking. Rather, the voters were informed by the Legislative Analyst that Proposition 103 provided for a 20% rollback and Cali-

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tion of compensation of agents does not mean that such regulation exceeds statutory authority." The court found authority for the Commissioner's regulations in a statutory provision which expressly authorized the Commissioner to adopt such reasonable rules and regulations as may be necessary to carry out the provisions of the article.

fornia would become a pre-approval state, like many others.

The Commissioner acknowledged the inconclusiveness of voter intent, at page 40 of his brief, when he stated: "There is no evidence the voters considered to what extent the Commissioner would find it necessary to resort to the adoption of regulations to implement Proposition 103."

This court concludes that voter intent is, at best, inconclusive as to the scope of the Commissioner's power to adopt substantive rollback regulations.

Interpretation of *Calfarm* is thus at the core of the issue of the Commissioner's authority to adopt rollback regulations and the extent of such authority, and to other issues raised herein as well.

With respect to the Commissioner's power to adopt regulations, *Calfarm*, at page 824, states:

> Much is necessarily left to the Insurance Commissioner, who has broad discretion to adopt rules and regulations as necessary to promote the public welfare. [Citation] . . . No provision bars the Commissioner from consolidating cases or issuing regulations of general applicability. Thus, there is nothing here which prevents the Commissioner from taking whatever steps are necessary to reduce the job to manageable size. . . .

Relying on *Calfarm*, this court ruled early on that the Commissioner has the power to promulgate rollback regulations of general applicability, and that in accordance with *Calfarm*, no review of regulations would take place until after they are applied in a company-specific hearing. Several appellate cases have made similar rulings. See *SAFECO, State Farm, Wilshire, Allstate*. As noted earlier, no case has dealt with the scope of the Commissioner's substantive rulemaking authority, and that is a pivotal issue herein.

No one could reasonably contend that *Calfarm*'s statement that the Commissioner has broad discretion to adopt regulations necessary to "promote public welfare" means that the Commissioner can adopt just any regulations promoting public welfare. This language has to be interpreted in light of the cases relied on by the Supreme Court and the context in which the statement was made.

As to the context, the statement was made in relation to the *Birkenfeld v. Berkeley* problem of the necessity to provide efficient, speedy, effective relief from possibly confiscatory statutory rates. That context alone and *Calfarm*'s references to reducing the job to manageable size and consolidation might lead to the conclusion, as contended by the insurers, that only procedural type regulations were contemplated by *Calfarm*.

However, *Calfarm*'s reference to *Credit Insurance General Agents v. Payne, supra,* indicates a recognition of discretion to adopt substantive regulations if such regulations are impliedly authorized by and are not inconsistent with the statute they seek to implement and are designed to carry out its purposes. Because *Calfarm* modified Proposition 103 with respect to rollbacks, the scope of the Commissioner's authority to adopt regulations must be determined in light of Proposition 103 as modified by *Calfarm*.

Calfarm invalidated section 1861.01(b) and held that "standards set by section 1861.05, subdivision (a), govern rate regulation during the first year of the initiative's operation" (*Calfarm,* at 823), and that this general standard is operative "from the effective date of the initiative." (*Calfarm,* at 822.)[15]

By emphasizing different parts of the decision, the insurers on the one hand, and the Commissioner and Voter

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[15] This decision is concerned only with determination of rollbacks and rollback regulations, and does not deal with prior approval of insurance rates after November 8, 1989. "Rollback year" herein refers to November 8, 1988 to November 8, 1989.

Revolt on the other, reach different conclusions as to the meaning and scope of Proposition 103 as modified by *Calfarm*.

Thus, the insurers contend that *Calfarm* held: that the Commissioner must apply section 1861.05 excessive/inadequate standard, as traditionally interpreted in prior-approval statutes,[16] to the section 1861.01 rollback determinations; that under that standard, the Commissioner has no authority to make or set rates or rates of return, but must approve *any rate* filed for by the insurer unless it is "inadequate" or "excessive"; that courts have recognized that there is a range of fair rates between these two extremes, and the insurer's rate must be approved if it falls anywhere within that range.[17]

The Commissioner admits that the section 1861.05 excessive/inadequate standard was disregarded in the rollback regulations and was not applied to determination of 20th Century's rollback liability. (Opposition, pp. 54-55, 66.) The Commissioner contends that *Calfarm* did not hold "that section 1861.05 would become the exclusive standard for determining an insurer's rollback obligation" and cites to "directives to the Commissioner to grant rollback exemptions only to the extent necessary to prevent confiscation." (Opposition, at p. 64.) The Com-

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[16] See 20th Century's amended memorandum of points and authorities in support of petition for writ, pages 12-15, and brief of amicus American Insurance Association, pages 12-17, for a detailed discussion of the "well-established meaning of 'excessive, inadequate, unfairly discriminatory' which obtains in the actuarial profession."

[17] 20th Century cites *CAARP v. Garamendi* (1991) 232 Cal.App.3d 904, 911-912, and *Wilshire Insurance Company v. Garamendi* (1992) 5 Cal.App.4th 1573, 1580, as supporting its position. (20th Century Brief, pp. 14-16.) Both cases acknowledged the *Calfarm* holding that § 1861.05 standards govern rollbacks pursuant to § 1861.01. So did *Safeco* and *State Farm*. None, however, faced the issue of Commissioner's power to adopt the specific regulations at issue or the extent of such power.

missioner maintains that Proposition 103 thus modified by *Calfarm* provides him with authority to adopt the regulatory scheme and regulations at issue herein.[18]

This court concludes that the insurer interpretation ignores the fact that *Calfarm* held section 1861.01(a), the 20% rollback provision, facially constitutional, subject only to the limitation that the insurers be left with a fair, nonconfiscatory rate of return for the rollback year.

The Commissioner's and Voter Revolt's interpretation, on the other hand, ignores the plain language in *Calfarm*, that section 1861.05(a) standards "govern rate regulation during first year of the initiative's operation." It also disregards *Calfarm*'s requirement that the rollbacks must leave the insurers with a fair rate of return for the rollback year and transforms the Commissioner into a full-blown ratemaker, contrary to Proposition 103 as modified by *Calfarm*.

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[18] This position appears to be inconsistent with the position taken by the same counsel on behalf of the Attorney General before the Supreme Court in *Calfarm*. Describing the effect of striking the insolvency standard, counsel argued that (see Second Post Hearing Supplemental Brief of 20th Century, pp. 4-5, fn. 4):

> "What would be left . . . is a rollback of rates to November 1987 levels, a 20% reduction in those prices and no prohibition against immediate raising of those prices. The operative standard would be that prescribed by voters for the permanent rate-approval system, that rates not be excessive, inadequate or discriminatory (Ins. Code § 1861.05, subd. (a)), the standard employed nearly uniformly across the country. Carriers would, during the first year of the initiative, still be required to file a rate-change application (Ins. Code § 1861.05, subd. (b)), but the change could go into effect immediately . . . The Commissioner could institute a hearing during this year and, if she found rates excessive, order them reduced (Ins. Code § 1861.05), but, for this first year, those rates would be collected until she ordered otherwise. In effect, then, California would, for a year, have a file-and-use system of regulation, much like many other states, a system of regulation far stronger than existed before, but not as potent as the prior-approval system in effect after the one-year phase in."

This court concludes that:

(1) *Under Calfarm, the Commissioner must approve any rollback rate filed by the insurer, if that rate produces only a lower-end reasonable rate of return on the range of reasonable returns, and must disapprove any rate which produces a higher, though still reasonable, rate of return.*[19]

This interpretation gives effect to section 1861.01(a), held valid by *Calfarm,* and to *Calfarm*'s considerable discussion that the rollback may not deprive the insurer of a reasonable rate of return for the rollback year. It also effectuates *Calfarm*'s ruling that section 1861.05 standards apply to rollbacks, though within the parameters provided by the other rulings.

A reasonable rate of return under *Calfarm* does not mean a break-even rate of return, but one that produces a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital. (See *Hope, supra; Guaranty National Insurance Co. v. Gates* (9th Cir. 1990) 916 F.2d 508.)[20]

(2) *Calfarm authorizes the adoption of regulations as to lower boundary reasonable rate of return.*

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[19] "Rate" refers to the rate or price charged to the insured for insurance (the premium) and "rate of return" refers to the profit made by, or allowed to, the insurer on its investment. Many cases and the briefs at times seem to use the terms interchangeably.

[20] A more detailed discussion of the applicable standard appears elsewhere. It should be noted at this juncture, however, that *Calfarm*'s reasonable rate of return mandate is inconsistent with the insurers having to establish deep hardship to obtain relief from the Commissioner's rate, which, because of the operation of the formula, always produces a lower return than even 10%. A rate which only avoids deep hardship does not guarantee a fair rate of return and is inconsistent with *Calfarm. Calfarm* precludes any rate which does not guarantee a reasonable rate of return (though a lower boundary rate of return) in the rollback year.

Calfarm's statement as to the Commissioner's power to adopt regulations contemplates power to adopt regulations to the extent necessary to implement Proposition 103 as modified by *Calfarm*. The Commissioner has, of course, no power to adopt regulations inconsistent with Proposition 103 as modified by *Calfarm*.

To give effect to section 1861.01(a), which was held facially constitutional, the Commissioner must determine the lower boundary reasonable rate of return. Any higher reasonable rate of return on the range of reasonable returns would produce a smaller rollback than contemplated by Proposition 103.

Adoption of a regulation simply setting a lower boundary reasonable rate of return facilitates the rollback determination and is not inconsistent with Proposition 103 as modified by *Calfarm*. Whether the rate of return determined in section 2645.6(a) is arbitrary in light of the RCD-2 record and/or unconstitutional, and to what extent it can be challenged in an 1861.08 hearing or pursuant to constitutional hearing requirements will be discussed hereafter.

The Commissioner also has implied power to adopt regulations defining the capital base to which the minimum reasonable rate of return applies and regulations defining unreasonable or imprudent expenses for the rollback year, as such regulations are also reasonably necessary to implement Proposition 103 as modified by *Calfarm*.[21]

(3) *Calfarm does not provide authority for the regulations adopting and applying the formula to produce a rollback rate.*

The regulations defining the formula and its components, applicable to rollbacks, have been set out in full, *supra*.

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[21] **By way of dictum and without focused or thorough review, it may be that most of Commissioner Gillespie's regulations might have been within the *Calfarm* authority to adopt regulations.**

Only those aspects of the regulations directly in issue in this action and which serve as the basis for this court's conclusion that *Calfarm* does not authorize such ratemaking will be elaborated on here.

Significantly, the rollback determination under the formula is not based on an insurer's actual 1989 earned premiums, but on a "minimum permitted earned premium" produced by the formula and the various assumptions embodied in it and its various components.[22]

The formula is a recursive formula, and several of its components are themselves formulas.

Besides 1989 losses, ALAE and ancillary income, the numerator of the formula includes fixed expenses. Fixed expenses in the formula, however, do not represent the insurer's actual 1989 fixed expenses.

Rather, for rollbacks, fixed expenses shall be the lower of actual fixed 1989 expenses, reduced by excluded expenses or "the quantity specified in section 2644.12," meaning fixed expenses capped by the use of efficiency standards as computed by the section 2644.12 sub-formula.

Section 2645.5(c) provides three sets of efficiency standards for three different distribution systems: captive writer, direct writer, and independent agency.[23]

Even if an insurer's actual 1989 expenses are less than the result of the application of the relevant efficiency standard to its 1989 earned premium, those expenses are not used in the formula. The application of sub-formula contained in section 2644.12 determines the maximum fixed expenses by multiplying the *minimum permitted earned premium* by the product of the efficiency stand-

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[22] **The rollback amount is the difference between the formula's minimum permitted premium and the actual premiums received.**

[23] **No administrative record is provided as to how any of the efficiency standards are determined, but the briefs indicate they are percentages of "historic earned premiums".**

ard,[24] less the variable expense factor. Because instead of 1989 actual earned premiums, the lower artificial minimum permitted earned premium is used, the effect is to understate the fixed expenses. Thus, a company that "passes" the efficiency test based on its actual 1989 experience may, nevertheless, fail the formula "efficiency standard."

The formula denominator consists of four numbers, all of which are assumed or hypothetical.

The variable expense factor (section 2644.14) consists of the commission rate and the state premium tax rate. Instead of using the actual 1989 numbers for these items, percentages are used and ultimately the insurer gets credit not for the 1989 commissions and premium taxes *it actually paid,* but for commissions and taxes calculated by multiplying the commission and tax rates by the *minimum permitted earned premium.* Thus, in every case, a portion of these legitimate and reasonable expenses is ignored in determining the rollback.

The profit factor consists of the 10% lower boundary rate of return, the leverage factor and federal income tax factor, and is determined by multiplying the leverage factor by the federal income tax factor and dividing the result by the 10% rate of return.

The various leverage factors reflect the amount of surplus the Commissioner believes the insurer should have had during the rollback year for a given line of insurance (section 2644.17; section 2645.6). Thus, if an insurer's

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[24] Again, the insurers state that this efficiency standard is derived from "mean average" of expenses incurred nationwide in each Proposition 103 line by insurers doing business in California and the nationwide "mean average" expense level is averaged by expense levels in other lower cost states. There is no record before the court as to how the Commissioner arrived at the efficiency standard, and whether it has any factual basis is not before this court.

surplus was greater than the leverage factor would allow, the formula ignores the actual leverage ratio and replaces it with the leverage factor (section 2645.6). Even when an insurer's "actual" [25] leverage ratio is used, the insurer does not earn a return on all of its surplus because the formula relates the leverage factor as a function of the *minimum earned premium,* with the result that surplus is calculated by dividing the *minimum earned premium* by the higher of the leverage factor or insurer's "actual" leverage ratio. How much surplus is disregarded by the operation of the formula is demonstrated in the table at page 8 of Reply Brief of State Farm Insurance Company. Because the leverage ratio in the formula is a function of the minimum permitted earned premium, even if a company uses its own actual leverage ratio, it is not allowed the 10% return on its actual surplus. The 10% return is thus really not a return on surplus, but on a percent of the minimum permitted premium.[26]

Lastly, the denominator contains a rather complex investment factor, which will not be belabored here as no issues in this case focus on this component.

A much more detailed description of the formula and how it works can be found in various insurer briefs.[27] It is clearly a ratemaking formula.

In the cases relied on by the Commissioner, the enabling statutes, unlike Proposition 103, expressly conferred

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[25] As several briefs explain, the "actual" leverage ratio itself is based on artificial allocation of an insurer's total surplus to lines of insurance.

[26] A discussion of this is contained in Reply Brief of Cal Casualty Group and CSAA at pages 4-6; see also Brief of State Farm Insurance Company on the issue of leverage, pages 1-19.

[27] See brief of amicus American Insurance Association, pages 14-15, Hartford (amicus), pages 3-13, Reply Brief of State Farm, pages 3-12, Reply Brief of California Casualty Group and CSAA, pages 3-11.

substantive ratemaking authority on the regulator, often including specific directives concerning limitation on certain costs and other factors to be considered. (See, for example, *Barasch v. Pennsylvania Public Utilities Comm.* (1987) 516 Pa. 142 [532 A.2d 325]; *City of Chicago v. Federal Power Comm.* (1971) 458 F.2d 731; *Duquesne Light Company v. Barasch* (1989) 488 U.S. 299; *Federal Energy Regulatory Comm. v. Pennzoil* (1979) 439 U.S. 508; *TWA v. CAB* 385 F.2d 648; *Hope* and *In re Permian Basin Area Rate Cases, supra.*) California Public Utilities Commission derives this ratemaking authority from California Constitution, article XII, sections 5 and 6. Furthermore, the ratemaking in these cases was applied with respect to future rates, not to determine a one-time rollback.

Similarly, no precedent for *insurance* ratemaking has been cited, except pursuant to express statutory authority. (See Mass. Gen. Laws, Ann., ch. 175E, § 5 (West, 1987) (authority to "fix and establish" auto insurance rates); Tex. Rev. Civ. Stat., Ann., art 5.01 (Vernon 1991) (authority to "fix, prescribe and promulgate auto insurance rates). See also 20th Century's Amended Memo of Points and Authorities in Support of Petition . . ., pages 32-33, for discussion of statutes (N.Y., S.C., N.J.) which provide for refunding of "excess profits," including California's Insurance Code section 1861.04, repealed in 1989.)

Proposition 103 did not provide that the Commissioner shall fix, prescribe, or set rollback rates.[28] Nor did *Calfarm* hold that the Commissioner should become a ratemaker. Rather, *Calfarm*'s ruling that section 1861.05 inadequate/excessive standards, found in the "laws of most states," apply to the rollback year, means that the Com-

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[28] **With various statutes in existence authorizing ratemaking, it should have been very easy to include in Proposition 103 similar language, so the voters could have voted for ratemaking, if they desired the elected Commissioner to be a ratemaker.**

missioner may not adopt regulations making a rollback rate of his own, as these standards do not authorize ratemaking. Under these standards, as all agree, there is a range of reasonable rates of return, and a rate filed by an insurer must be approved if it produces a return anywhere within that range.[20] Furthermore, the inadequate/excessive standard must produce a reasonable rate of return, not a return which simply avoids hardship.

That *Calfarm* did not authorize the Commissioner to become a ratemaker with respect to rollbacks is apparent also from specific language, apart from the mandate that section 1861.05 standards apply.

At page 822, *Calfarm,* refers to the section 1861.05 standard as a "general standard for rate *adjustment.*" At page 815, *Calfarm* refers to refunds with interest of any premium collected in excess of the rates "ultimately approved."

"Rate-setting" is used throughout *Calfarm,* not in the sense of ratemaking, but in the sense of the Commissoner's decision on a rate application or, generally, a rate determination by statute, the regulator or regulatee.

For example, "prices set by seller" (page 820), "insurers set their own rates" (footnote 15, page 823), "rate-setting standard of section 1861.05," and "voters would presumably prefer rate-setting and regulation under balance of initiative to the method of setting insurance rates which existed before the initiative" (page 822). (Rates before the initiative were not "set," but determined by the insurers in the competitive marketplace.)

The sole discussion as to the "end result" test is in the context of finding section 1861.01(a) facially valid, not in the context of the Commissioner's function in applying section 1861.05 standards to the rollback determina-

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[20] As to rollbacks, lower boundary reasonable rate of return must be determined in the process of deciding whether the rate applied for by the insurer should be approved.

tions. The "end result" required under section 1861.05 and *Calfarm* is that whatever rollback is ordered, it must leave a reasonable return to the insurer, though at the lower boundary of the range of reasonable returns. (See, also, *Jersey Central Power & Light v. F.E.R.C.*, 810 F.2d 1168, 1177-78 (D.C. Cir. 1987).)

The formula is unique and, as contended by the insurers, inconsistent with the way similar statutes containing the widely used inadequate/excessive standard have been implemented. In fact, the Commissioner was unable to identify any precedent for his rollback formula, though he cited to the New Jersey regulations as similar.

Although one can imply from *Calfarm* the power to adopt regulations regarding a lower boundary reasonable rate of return to facilitate the determination that the Commissioner must make under *Calfarm*, one cannot imply authority for the ratemaking formula. Applicability of the excessive/inadequate standard to rollbacks precludes such ratemaking. Furthermore, a formula which automatically and inherently produces a minimum permitted premium which unavoidably does not permit even the lower boundary generic reasonable rate of return of 10% determined by the Commissioner is inconsistent with the holding of *Calfarm* that the insurers are entitled to a reasonable rate of return.[30]

In short, with respect to the Commissioner's power to adopt regulations, this court concludes that the Commissioner has implied authority under Proposition 103, as modified by *Calfarm*, to adopt such regulations for deter-

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[30] The formula precludes a 10% return by use of the section 2644.12 efficiency standard, by the variable expense factor (section 2644.14) ignoring a portion of incurred necessary, legitimate, and reasonable commission and premium tax expenses, and by the leverage factor resulting in the disregard of part of actual surplus in the fair rate of return determination. Because the formula does not provide even a lower boundary reasonable rate of return, it is also unconstitutional.

mination of the lower boundary reasonable rate of return to implement and facilitate the determination of rollbacks. With respect to the formula, the Commissioner has no authority to adopt the formula to set a rate to determine rollbacks.

Based on the above, the unauthorized regulations, and order made pursuant thereto, are hereby declared null and void, and the Commissioner is enjoined from enforcing them or any order made pursuant thereto.

Accordingly, this court could at this point remand the case to the Commissioner for action consistent with this order.

However, to avoid delay in the event of remand by the Court of Appeal and/or the Supreme Court, this court will proceed to rule on other significant issues, including the as-applied issues raised in 20th Century II with respect to REB-5173.

X. 10% LOWER BOUNDARY REASONABLE RATE OF RETURN (RCD-2)

Section 2645.6(a) provides that "[t]he after-tax rate of return for property and casualty insurance, corresponding to the lower boundary of the range of reasonable returns, is 10%."

As this court has concluded that under *Calfarm* the Commissioner has authority to adopt regulations as to lower boundary reasonable rate of return and the capital base to which it applies, the scope of review of the RCD-2 determinations and section 2645.6(a), which embodies them, is the arbitrary/capricious standard.[31]

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[31] Based on *Safeco* and *State Farm*, this court has ruled, *supra*, that the arbitrary/capricious standard applies to the review of the generic determinations as well as regulations. Consequently, the insurer arguments, that only evidence in the record can be considered, do not apply. Rather, the "legislative fact" cases which allow regulators to make determinations based on matters not included in the record apply. See *Schenley Affiliated Brands v. Kirby* (1971) 21 Cal.App.3d 177, 196-198.

The insurers contend that the 10% rate of return is not a reasonable rate of return, but arbitrary and capricious, and not supported by the record.

Further consideration of *Calfarm*'s definition of fair and reasonable return is in order at this point.

The Commissioner contends that *Calfarm* holds, in essence, that constitutional confiscation does not occur as long as the regulated entity's capital is preserved, and even zero profit is non-confiscatory. (Commissioner's Brief, pages 137-138 and 162-163.)

That is not how this court reads *Calfarm*. In striking down the insolvency standard, *Calfarm* held that the insurers were constitutionally entitled to a fair and reasonable rate of return, and in its discussion of the insolvency standard made it clear that a break-even standard was inadequate. With respect to the rollback year, at page 821, the Supreme Court observed that the insurance problem was a chronic situation which "will not be solved by compelling insurers to sell at less than a fair return for a year."

Calfarm defined fair and reasonable return in terms of *Hope*. According to *Hope*, in determining a fair rate of return, one must consider "the financial integrity of the company whose rates are being regulated. . . . [I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on debt and dividends on stock. [Citation.] By that standard the return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and attract capital. [Citation.]" (*Hope*, 320 U.S., at 603.)

This court is not alone in concluding that *Calfarm* requires a fair and reasonable rate of return, as defined in

Hope, for the rollback year. The Ninth Circuit Court of Appeal in *Guaranty National Insurance Company v. Gates* (1990) 916 F.2d 508, interpreting the Nevada rollback statute in light of *Calfarm* and *Hope,* noted that the applicable standard required that the return be sufficient to cover not only "operating expenses" but also capital costs of the business, and that the return be commensurate with returns on investments in other enterprises having corresponding risks. The Nevada statute was held unconstitutional because its formula permitted only marginal or break-even rates.

In addition to *Hope, Calfarm* cited also from *Jersey Central Power and Light Co. v. F.E.R.C.* (D.C. Cir. 1987) 810 F.2d 1168, 1170, to the effect that general financial integrity and ability to pay dividends and maintain access to capital markets were to be considered. *Jersey Central,* at page 1175, also observed that "the *Hope* test defines the point at which a rate becomes unconstitutionally confiscatory. . . ."

Permian, stressed by the Commissioner, was not the case relied on by *Calfarm* as establishing or defining what constitutionally may or may not be a reasonable return in determining rollbacks. Other than noting that *Permian* involved a facial attack on rates, *Calfarm* cited *Hope* and *Jersey Central* as defining fair and reasonable rates of return.

Hope, of course, recognized that "balancing of the investor and consumer interests must also take place." That factor, then, cannot be ignored in evaluating whether the lower boundary reasonable rate established by the Commissioner is arbitrary and capricious and not supported by the record. *Hope* precludes a confiscatory rate, but does not preclude a lower boundary reasonable rate of return on the range of reasonable returns.

The RCD-2 Proceeding

Determining rates of return is not an exact science, and indeed requires exercise of judgment. The different rates of return found to be reasonable by Commissioner Gillespie and Commissioner Garamendi for the rollback year are an example of how reasonable minds can arrive at different results and how evidence is available to serve as basis for varying conclusions.

In paragraph 22 of his Findings and Determinations, Commissioner Garamendi, after "considering all the evidence presented," found that an after-tax rate of return of 10% on statutory surplus corresponds to the lower boundary of the range of reasonable returns, and that such a "rate of return is nonconfiscatory." (RCD-2 05724.)

Evidence supporting the Commissioner's determinations included the testimony of Dr. Andrew Safir,[32] and that, in his opinion, 10.3% rate of return on SAP was the lower boundary reasonable rate of return. This opinion was based on the individual performance between 1985 and 1989 of a sample of insurers doing business in California.[33] Dr. Safir's study showed that insurance company profits varied greatly, a substantial number of companies earning negative net income each year and a large number earning substantial profits each year. (Safir Direct, exhibit C, page 8; Safir Reply, exhibit E, page 6; RCD-2 10576-10595.) The bulk of the distribution fell between —20% and +40% return on equity, with unrealized capital gains included. (RCD-2 10594.) Dr. Safir concluded that the proper boundaries for the zone of reasonableness were to be drawn symmetrically about the mean,

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[32] Safir's qualifications are set forth at Commissioner's opening brief, page 144.

[33] It is Dr. Safir's view that investors' expectations are shaped largely by historic profit levels of the companies making up the industry. (RCD-2 10554-55, 10579.)

at the 25th and 75th percentiles. (RCD-2 10558-59, 10579.)

Furthermore, Dr. Safir applied two normative rules. First, that the lower boundary of the zone of reasonableness must be below the average (historical returns), and secondly, that such lower boundary must not fall below the risk-free rate, which in 1989 was 8.12% (for 3-month treasury bills). (RCD-2 13885, RCD-2 10587-9, 14469.)

Dr. Safir further adjusted his results for the data having included in income unrealized capital gains. (RCD-2 10580-2, 13966-75, 14322, 14356, 15603.) He made another adjustment to this rate of return to reflect the difference between 1.75 to 1 premium-to-leverage ratio of the industry during the historic period and the higher normative industry-wide leverage ratio of 2.5 to 1 proposed by the department, ultimately arriving at 10.3% as the recommended lower boundary rate of return for rollback purposes. (RCD-2 10582-86.)[34]

The validity of Dr. Safir's 10.3% rate of return as at the lower boundary reasonable rate of return was confirmed by other evidence. Thus, his figure was above the level characterized as "accepted norm" for profitability by *A.M. Best Co.* (RCD-2 10562.) Furthermore, during the ten years when the industry average had been 10% return on equity, the surplus grew substantially, and even at that low level the industry had been able to meet debt obligations and pay dividends. (RCD-2 14627-8, 14922-23.)

Dr. Safir looked at a number of companies that earned up to one percent less than his recommended rate of return (between 9.3% and 10.3% exclusive of unrealized capital gains), and found that out of 48 such companies,

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[34] **A more detailed summary of Dr. Safir's study can be found in the Commissioner's Findings and Determinations. RCD-2 000128-130, ER 0070-0073.**

45 had surplus growth, adding a net $1 billion during the year in which they fell below 10.3%. (RCD-2 10586.)

Some of the above was confirmed by 20th Century witness, Dr. Timothy Crichfield. For example, Dr. Crichfield confirmed that most of the surplus growth was from retention of earnings, not attraction of new capital (RCD-2 15836-41, 13041, 13043, 13047-8) and that a number of low-earning companies were able not only to retain earnings, but attract capital. (RCD-2 15845-7.)

Further, evidence in the record showed that in 1989 the insurance industry earned an average return of 9.1% on statutory equity or 9.6% on GAAP (exhibit I, RCD-2 13414). Over the ten years 1980-1989, the industry averaged 10% return on both SAP and GAAP. Nevertheless, the industry's accumulated capital grew significantly. (RCD-2 3975-77, 14723, 15330-1, 15744-55.)

This court finds exhibit I, the Insurance Information Institute fact book, is satisfactorily authenticated and in accordance with the evidentiary standards applicable to administrative proceedings under Government Code section 11513. There is no reason to doubt that the exhibit presents data of the industry average profit level for 1980 through 1989, and no other data has been presented that the figures are inaccurate.

The insurers criticize the whole approach of relying on industry's historical average and industry average for 1989 to determine cost of capital for the rollback year, as inconsistent with the *Hope* standard. (Petitioner's Amended Memorandum of Points and Authorities, pp. 62-64; Amended Intervenor Allstate Insurance Company's Memorandum of Points and Authorities, pp. 6-15.) Nothing in *Hope,* however, precludes a generic lower boundary reasonable rate of return determination, if such rate of return assures the financial integrity of the business and is sufficient to attract capital.

There are indeed limitations to the historic average approach. As the insurers point out, the fact that an industry or firm has had low profits for five years or ten years does not necessarily mean that it is a low-risk enterprise or can attract capital even with low rates of return. Similarly, the number of years chosen to include in the average affects the result considerably. Thus, per exhibit I, the five-year average is 10.4%, the four-year average 12.4%, and the three-year average 11.8%. Commissioner Garamendi chose a ten-year average in his conclusion. (Commissioner Gillespie previously had used a 15-year average.) Certainly, a rate of return determined on this basis has to be viewed with caution and in the context of other evidence, and there must be an opportunity to show why it is confiscatory as to a particular insurer. This issue will be discussed further elsewhere.

The insurers presented testimony of economists, Dr. Appel and Dr. Vander Weide, regarding two theoretical models for estimating investor profit expectations and determination of the return necessary to attract capital: the discounted cash flow model ("DCF") and capital assets pricing model ("CAPM"). These models produced 16.98% and 16.6% rates of return. (RCD-2 903, 342.) Depending on assumptions, these rates, too, could vary substantially. See discussion of the Commissioner (Opposition Brief, pages 164-166). Dr. Vander Weide also estimated capital cost based on the risk premium method, arriving at a similar (15.5%) result. (RCD-2 13342-43, RCD-2 344-46.)[35]

The insurers also argued that although utilities are less risky, Pacific Gas and Electric and Southern California Edison were allowed a 13% rate of return in 1989 by the Public Utilities Commission.

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[35] Dr. Vander Weide's range of reasonable returns, based on the DCF model, was between 13.8% and 20.3% (RCD-2 367). It is really rather obvious from the record herein that all models can be manipulated/applied to produce a great range of rates of return.

The Commissioner responds that the utilities, unlike insurance companies, hold depreciating assets, and the Public Utilities Commission, unlike the Commissioner, was not looking for a rate at the lower boundary of reasonable rates of return for purposes of determining a one-time rollback.

In coming to his determination, the Commissioner considered that unlike utilities, insurers do not generally raise capital by attracting investors or borrowing, but primarily by internal growth (RCD-2 14628, 14745-6, 14767, 15629), and that therefore, such capital acquisition is free of the transactional costs associated with securties markets. In evaluating all of the evidence presented, the Commissioner considered also that unlike utilities, where heavy stock and bond issuances provide market data on cost of capital, only poor market data was available as to insurer cost of capital and, therefore, less credence could be placed on such data by the regulator.

In concluding that unrealized capital gains must be taken into account in the ratemaking process to "avoid setting rates higher than appropriate," the Commissioner again considered the distinction between utilities and insurers. Thus, the Commissioner found that the insurers have been able to attract capital despite returns that lag behind other industries because, unlike other industries, much of their investment value is in appreciating investments. (RCD-2 5723, cf. TW 4665.) Thus, in 1989, while the property-casualty insurance industry reported a return of 9.6%, its surplus grew 13.1%; while reporting income of $11.2 billion, the insurance companies were increasing in value by $15.5 billion. (RCD-2 3914.)

The Commissioner also stressed that the rollback is a one-time event, unlike utilities where the rate of return applies for the indefinite future. A one-year rate of return at the lower end of reasonable rates, he reasoned, is not likely to affect investor expectation so that attract-

ing capital plays a diminished role in the fair rate of return calculus.

According to the Commissioner, while utility ratemaking is prospective, Proposition 103 rollbacks "present a rare instance where the financial conditions for the relevant period are known. . . ." (Opposition Brief, page 147). His determination to rely on available annual historical industry-wide data, and not rely exclusively on analysts' hypothetical projections on what rates should have been, is not arbitrary and capricious. The Commissioner cites *Permian* as authority for the historical average approach to rate of return determination, in that, in *Permian,* evidence of an average rate of return for nine companies over five years was utilized.

Use of past data, along with other factors, in determining a reasonable rate of return for a past limited period (one year in the case of the rollbacks) is not improper. The cases cited by *Allstate* criticize use of historical data for prospective ratemaking. (See *Public Services Comm. v. F.E.R.C.* (1987) 813 F.2d 448; *Tennessee Gas Pipeline Co. v. F.E.R.C.* (1991) 926 F.2d 1206.)

The insurers have pointed to serious flaws in the evidence supporting the Commissioner's determination of 10% as the lower boundary reasonable rate of return. It is certainly true, for example, that Dr. Safir's opinion as to the proper rate of return is based on the premise of "capital preservation" (a standard inconsistent with *Hope* and *Calfarm*) and that Dr. Safir acknowledged that it was "marginal". (RCD-2 10565.)

Under the arbitrary/capricious standard, however, this court cannot reweigh the evidence and substitute its own judgment for that of the Commissioner.

The Commissioner considered not only Dr. Safir's opinion testimony, but other evidence in the record as well. He further considered a number of factors which dis-

tinguish the insurance business from other businesses, and utilities in particular.

The court considers all of the factors relied on by the Commissioner relevant and proper considerations in setting the lower boundary reasonable rate of return on the range of reasonable rates of return in determining rollbacks. Of particular significance is the fact that the rollback is a one-time event, applicable to a past period and is, thus, less likely to affect future expectations of invesors than if all future rates were to be limited by the same 10% lower boundary rate of return.

Constrained by the narrow scope of its review, this court concludes that there is substantial evidence in the record to support the 10% lower boundary reasonable rate determination for the rollback year, and such determination is not arbitrary or capricious.

The insurers also complain that the 10% return is allowed only on their surplus, which is a measure of capital under statutory accounting principles (SAP), rather than on their equity as measured under generally accepted accounting principles (GAAP). They argue that SAP principles, which were developed primarily to evaluate and maintain insurer insolvency, disregard the value of some significant assets, resulting in a considerably lower return on equity measured under GAAP. The Commissioner responds to this contention [86] by pointing to cases which hold that, constitutionally, a company is entitled to a reasonable rate of return on the fair value of its property at the time the property is used for public service. The Commissioner cites *Denver Union Stockyard Co. v. U.S.* (1938) 304 U.S. 470, *Contra Costa Water Co. v. Oakland* (1911) 159 Cal. 323, *Bluefield Co. v. Public Service Comm.* (1923) 262 U.S. 679, and *Barasch v. Penn. Public Utilities Comm.* (1987) 516 Pa. 142, af-

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[86] No record is before the court from the proceeding resulting in the adoption of the regulation.

firmed *sub nom. Duquesne Light Co. v. Barasch* (1989) 488 U.S. 299, for the proposition that the return which the regulated company is entiled to earn relates only to the investment of capital presently employed in public service. The Commissioner analogizes that allowing the return only on surplus is reasonable because that is what is employed in public service by insurers, and "surplus-surplus," retained earnings and investor capital, beyond the amounts necessary to support insurance operations, is not "used and useful" in providing service to the rate-payers.

This court concludes that this is not an arbitrary and capricious conclusion, and in considering the public interest as he was bound to do under *Hope,* the Commissioner could well conclude that the rate-payers need not provide a return on capital which is not required for insurance business. This approach has been approved in *Application of Insurance Rating Board* (1973) 63 N.J. 413, 30782604.

Considering the narrow arbitrary capricious scope of review, this court cannot conclude that the RCD-2 record does not adequately support the Commissioner's conclusion that 10% rate of return is the adequate lower bounds of the reasonable rates of return. Neither can this court conclude that applying the rate of return to surplus as opposed to GAAP equity is arbitrary or capricious and facially invalid.

XI. RIGHT TO ADJUDICATORY HEARING AND SECTION 2646.4(e)

Proposition 103 section 1861.08, as relevant, provides that hearings shall be conducted pursuant to sections 11500 through 11528 of the Government Code, which sections provide for adjudicatory hearings. The Court of Appeal recently, in the *Safeco Insurance Co. v. Gillespie* case (petition for review to California Supreme Court pending), stated that section 1861.08 merely requires a

hearing in conformity with APA adjudicatory procedures on each company's contested rate application, as distinguished from those determinations which under *Calfarm* may be made by the Commissioner in a regulatory proceeding.

Whether this ruling may or may not be dictum, this court will follow the Court of Appeal's interpretation with respect to section 1861.08 and will consider only whether an adjudicatory hearing is *constitutionally* required herein, an issue clearly not reached in *SAFECO*.

In upholding the 20% rollback against facial invalidity, *Calfarm* cited *Permian* and other cases for the proposition that rate statutes are seldom held invalid on their face. *Calfarm* stated, at page 817, the following: "Recognizing that virtually any law which sets prices may prove confiscatory in practice, courts have carefully scrutinized such provisions to ensure that sellers will have adequate remedy from such rates." (*Calfarm,* at 817.) The Court, in footnote 7, cited as an example *City of Miami* and *Cromwell Assoc.*; each invalidated laws "which permitted administrative bodies to approve rent increases, but limited the maximum that could be granted." The courts in both cases reasoned that under the circumstances a greater increase might be required to avoid confiscatory rates, and thus, any absolute limit was facially unconstitutional. With respect to the 20% rollback, *Calfarm* emphasized that there was a very high risk that such rollback might be confiscatory, but ruled that the 1861.08 hearing provision, along with section 1861.09, the judicial review provision, satisfied the constitutional requirement for adequate relief from confiscatory rates.

Where "regulation by means of rules and schedules derived from evidence typical of the members of the regulated group" is utilized, such regulation is "subject to the right of any member to make a showing of sufficient deviation from the norm to warrant special treatment." (*Birkenfeld v. Berkeley* (1976) 17 Cal. 3d 129, 172; see

also, *Bowles v. Willingham* (1944) 321 U.S. 503; *City of Chicago v. Federal Power Commission* (1971) 458 F.2d 731. *Permian,* as *Calfarm* noted, was only a facial attack. But even there, the Supreme Court stated, at page 770, that the Commission had made provision for special relief. The court did not reach the issue of adequacy of such relief.

Regardless of voter intent and policy choice of the regulator, the Constitution requires an adequate remedy or relief from confiscatory rates. Individualized relief must be accorded where there is a high risk of confiscation as a result of regulation. (*Calfarm,* at 816, 817, 820, 825, 826.) Even cases where ratemaking has been expressly authorized by statute have recognized that the Constitution requires special relief be available to challenge general rates as confiscatory. (See *Chicago & Northwestern Ry. v. Atchison; Mobile Oil Corp. v. Federal Power Commission* (1974) 417 U.S. 283 (producers "may petition FPC for individualized relief. *Permian* contemplated it."); *Texaco Puerto Rico v. Rodriguez* (1990) 749 F.2d 348 (regulation found constitutional only because they provided right to seek individual relief from the generic profit factor). *Richardson v. Honolulu* (D. Haw. 1991) 759 F.2d 1477; *Fisher v. City of Berkeley* (1984) 37 Cal.3d 644.)

The insurers contend that the formula imposes on them a confiscatory rate without providing for meaningful variances, and that they are deprived of adequate statutory and constitutional relief from such rates by section 2646.4 (e), which, as relevant, provides:

> "Relitigation in a hearing on an individual insurer's rates of a matter already determined either by these regulations or by a generic determination is out of order and shall not be permitted. However, the administrative law judge shall admit evidence he or she finds . . . relevant [to the determination of the

> minimum nonconfiscatory rate], whether or not such evidence is expressly contemplated by these regulations, provided the evidence is not offered for the purpose of relitigating a matter already determined by these regulations or by a generic determination."

With respect to the formula, the minimum permitted premium/rate (if there were authority to engage in such ratemaking) as discussed in section IX, *supra,* always produces less than the 10% lower boundary rate of return and is, therefore, in addition to being inconsistent with Proposition 103 as modified by *Calfarm,* also unconstitutional.

Assuming, arguendo, that the Commissioner had the power to adopt the formula and the formula is not unconstitutional, there is no question that, for the reasons discussed in section IX, *supra,* it has an extremely high risk of being confiscatory.

As to section 2645.6(a), because the 10% is the lower boundary reasonable rate of return, it also presents a high risk of leaving a particular insurer with a confiscatory return. This risk is exacerbated by the 10% being based on industry-wide, historic average data.

This court concludes that an individualized hearing is constitutionally required, at which the insurer can proffer all relevant evidence to show that the 10% rate of return and the minimum premium produced by the formula is confiscatory as to it. Furthermore, under *Calfarm,* the standard applicable as to rollbacks is not deep hardship or insolvency, but whether the insurer is left with a reasonable rate of return, though at the lower boundary of the range of reasonable rates.

Only three variances from the formula's permitted premium are allowed. Two—section 2646.4(c)(4) and section 2646.4(c)(5)—are extremely narrow and not particularly relevant herein. The third—section 2646.4(c)(8)

—provides for an increase in the minimum earned premiums "to protect insurers' solvency." That, of course, is the standard held unconstitutional in *Calfarm*.

Section 2646.4(e), to the extent that it precludes admission and consideration of relevant evidence on the individual-insurer's rate of return, is invalid. Considering the nature of the formula, to the extent section 2646.4(e) precludes admission and consideration of company-specific relevant evidence with respect to any other of its components, it is invalid.

XII. 20TH CENTURY'S SECTION 1094.5 PETITION

As previously outlined, 20th Century challenges the rollback regulations, facially and as applied, on statutory and constitutional grounds, and also asserts that the REB-5173 hearing was unfair.[37]

(1) *The Formula and 10% Rate of Return as Applied.*

20th Century contends that the section 1861.05 excessive/inadequate standard was not applied at its company-specific hearing, pointing to the record at TW 0099, 14558-9, 55221. The Commissioner has conceded as much.

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[37] Both 20th Century I and II present a broad facial attack on the rollback regulations on both statutory and constitutional grounds and adequately raise all issues ruled on by this court. The facial validity of the leverage factor is raised by the consolidated *Hartford* issue. The REB-5173 record, though not necessary to the determination of facial invalidity, is useful in illustrating and demonstrating the inescapable effect of the regulations.

All "as applied" issues ruled on herein were adequately raised in REB-5173 and 20th Century II. (See the 170 findings of the administrative law judge, TW 2879-2946.)

The parties presented extensive arguments as to all issues decided and as to some issues, including treatment of taxes and future tax refunds, extensive supplemental post-trial briefing was permitted at the request of Voter Revolt.

This court has already ruled, *supra,* that under *Calfarm,* the Commissioner has authority to adopt regulations as to the lower boundary fair rate of return, but the excessive/inadequate standard applicable under *Calfarm* precludes adoption of the formula for a "minimum nonconfiscatory rate" for rollbacks. The regulations are thus invalid on their face, and the wrong standard was thus applied at REB-5173.

20th Century further contends that the administrative law judge erred also by requiring it to show "deep financial hardship" (TW 2822, 2823) to obtain relief from the allowable premium set by the formula. This court has also ruled earlier that allowing relief only on showing of deep financial hardship or insolvency, and denying a hearing on whether the lower boundary reasonable rate of return is confiscatory as to a particular insurer, is inconsistent with *Calfarm* and also unconstitutional.

Specifically, with respect to the 10% rate of return, 20th Century contends that 10% is confiscatory as to it and that unrebutted evidence shows that its minimum nonconfiscatory rate of return in 1989 was 20%.

20th Century contends that the RCD-2 findings and determinations (TW 2826, 2885, 2875), including "industry averages" and "industry historical returns," are irrelevant in the company-specific hearing because no evidence from the RCD-2 proceeding was introduced in the REB-5173 hearing, either directly or through request of judicial notice, and that use of such evidence is precluded by sections 1861.08 and 1861.09.

Although the administrative law judge initially was going to preclude all evidence offered "to prove any entitlement to a variance other than as expressly permitted by section 2646.4(d)" (TW 0099), she later allowed 20th Century to make a record as to its cost of capital.[38]

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[38] It is apparent that this was done for purposes of judicial review and the Commissioner's position is that the administrative

20th Century presented the testimony of Professor Stiglitz, Dr. Priest and Dr. Crichfield to the effect that 10% was not an adequate rate of return for 20th Century under the *Hope* standard, and that the lowest reasonable rate of return for 20th Century in 1989 was 20%. This testimony was based on widely accepted econometric models (DCF and CAPM), used also in utility rate-setting.[39]

There was no evidence presented by the department that the 10% generic lower boundary reasonable rate of return was adequate as to 20th Century, nor that 20th Century's expert testimony was flawed.

In rejecting 20th Century's evidence, the administrative law judge ruled that none of the models relied on by Dr. Stiglitz produced substantial evidence to support any of the figures he testified to, and that his credibilty was undermined by, among other things, his digressing in answering cross-examination questions. The insurer evidence was rejected also based on the Commissioner's RCD-2 determinations, which were neither offered in evidence, nor judicially noticed.

Pursuant to section 1861.09 and section 1856.08, this court reviews the determinations made in REB-5173 under the independent judgment scope of review.

In *Whispering Pines Mobile Home Park v. Scotts Valley* (1986) 180 Cal.App.3d 152, the court rejected a rate order because no proper evidentiary basis was presented from which the court could conclude that the rent control commission's rate of return was a fair rate of return for

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law judge is precluded from admitting and considering evidence of the cost of capital of any individual insurer as well as evidence on other issues resolved by the formula.

[39] Even Massachusetts, where insurance ratemaking is statutorily authorized, has employed the beta analysis in rate-setting. See *Massachusetts Auto Rating Bureau v. The Commissioner*, 424 N.E.2d 762, 770.

the property owner in question, and where the only evidence on the issue was the testimony of the property owner's expert that a higher return was required.

The court held that the agency could not reject the owner's expert testimony on rate of return and render its own determination based on "common knowledge and experience" about state of the economy, high interest rates, activity in real estate market, declining real estate values, etc. (*Id.*, at pp. 160-161.) The court said: "Assuming, arguendo, that these factors may be deemed legislative facts within the Supreme Court's contemplation in *Franz*, the landlord was not provided with notice and an opportunity to rebut them prior to the Commission's decision." (*Id.*)

This court concludes that DCF and CAPM models are commonly used to determine cost of capital generally, as well as in ratesetting, and that the testimony of Professor Stiglitz, Dr. Priest, and Dr. Crichfield constitutes substantial evidence that 10% rate of return is inadequate as to 20th Century and that 20th Century's lower boundary reasonable rate of return was at least 20%. There is no evidence in the REB-5173 record contradicting 20th Century's evidence, and thus no basis for rejecting it. Although *Hope* does not preclude a generic determination of a rate of return, it does contemplate (as does the inadequate/excessive standard) a rate of return which considers the capital needs of the regulated enterprise. What is missing here is evidence tying in the 10% return as reasonable for 20th Century. Based on the only evidence in the record, 10% is confiscatory as to 20th Century.

(2) *Inadequate and Confiscatory Rates in Earthquake and Other Low-Frequency, High-Severity Lines.*

In earthquake and other low-frequency, high-severity lines of insurance, all parties agree, actual losses and administrative expense in most years are much lower than premiums. However, when a major catastrophe occurs,

the claims incurred exceed the premiums collected in that year.

Furthermore, because of the significant risk of massive losses when a disaster occurs, insurers generally purchase re-insurance to prevent ruinous depletion of surplus or possible insolvency in the event of a major earthquake, floods, or other catastrophe. This is commonly done and is regarded as a proper and prudent practice. Even under the "used and useful" concept utilized in rate-setting, re-insurance expenses could not be legitimately disregarded.

The formula, however, uses "direct" rather than "net" premiums and losses in calculating the allowable premium (section 2645.9). As a result, premiums paid to re-insurers are ignored in computing expenses, and losses ceded to re-insurers are treated as if they were paid by the primary insurer and are counted in the computation of the minimum earned premium.

The Commissioner justifies this as achieving "symmetry" and consistency. Consistency and efficiency, however, can never be an end in themselves. The Commissioner also asserts that "direct" rather than "net data" is typically used in prospective rate-setting. However, as the Commissioner has previously argued with respect to establishing the proper rate of return, the rollbacks are a one-time, past event. No case cited by the Commissioner holds that a regulator may set a premium rate for any line of insurance which precludes the insurer from recovering legitimate reasonable expenses, such as re-insurance, necessarily incurred in writing that line of insurance. Nor is there authority for depriving the insurer from any premium for the risk assumed in a line of insurance.

Robert Hunter, a Department of Insurance witness at 20th Century's hearing, agreed that it made no sense to base earthquake rates on loss data from a single year (TW 6230) and that the minimum permitted earned premium

for the earthquake line was not "adequate" under the section 1861.05(a) standard applicable to prospectively filed rates (TW 6187).

As 20th Century contends, not only does the use of one-year losses preclude an insurer from receiving any reward for the risk of writing earthquake coverage, it also results in disallowance of even out-of-pocket costs because the rollback formula calculates permitted expenses as a factor of incurred losses. Limiting expense through the formula, which, in effect, caps expenses based on incurred losses, results in disallowance of legitimate, non-excessive expenses in a year where earthquake losses are low. In the case of 20th Century, the formula disallows $105,410 of the $253,188 in fixed expenses for the earthquake line under the efficiency standard (section 2644.12), and another $8,011 is disallowed under section 2644.10 (Excluded Expenses).

The Commissioner's formula and its reliance on a single year's loss data deprives 20th Century of any compensation for undertaking the risks involved in writing earthquake coverage in 1989, with a potential liability of $10 million-plus (TW 5835-5842).

Furthermore, the evidence in the record is undisputed that re-insurance was essential to 20th Century's ability to write earthquake coverage in 1989, and that its decision to re-insure was prudent. (TW 5640-46, 2791, footnote 13.) The record shows that in 1989 20th Century took in $8.7 million in earthquake premiums, and paid $4.4 million for re-insurance. Because there were no severe earthquakes, 20th Century's earthquake losses in 1989 were $629,532 with no re-insurance recoveries. 20th Century had out-of-pocket selling expenses for earthquake coverage of $615,861. Even though its legitimate, reasonable expenses were thus over $5 million, under the formula, 20th Century's allowed earned premium for earthquake line was only $933,020 (TW 2344). Thus, the formula provides 20th Century with an earthquake

premium which covers only approximately 16% of its legitimate out-of-pocket expenses.

Not only is 20th Century precluded from recovering its legitimate costs incurred in connection with the earthquake insurance business, but denial of such costs precludes it from receiving even the 10% lower boundary reasonable rate of return. This court concludes that such a result is clearly confiscatory as to 20th Century and unauthorized by Proposition 103 as modified by *Calfarm*.

(3) *The Formula is Also Confiscatory for Other Reasons.*

The record shows that 20th Century had SAP after-tax income of $76 million in 1989. The rollback ordered by the Commissioner is $78 million (plus interest), which leaves 20th Century with a negative return in 1989.

Some reasons why the formula produces a confiscatory result have already been discussed.

Another reason why the formula results in confiscation is the leverage factor. As testified to by Professor Stiglitz (TW 3292-95), leverage reflects risk. The Commissioner recognizes this as to prospective rates by allowing more highly leveraged insurers to use the "normative leverage factor" rather than its actual leverage. The result is a higher allowed rate of return to compensate such insurer for its greater risk. No such normative factor applies to rollbacks. (State Farm Opposition Brief, Part III.) As illustrated by the table on page 8 of Reply Brief of State Farm and discussed earlier, the formula actually disallows or disregards a significant amount of actual "proper" 1989 surplus, and the 10% return is, in effect, allowed on a percentage of the minimum allowed premium. This result is confiscatory on its face.

Application of the formula to 20th Century also resulted in disregard or disallowance of costs involved (commission and state premiums taxes) in the "variable expense" factor. (Findings 89-93.) During 1989, 20th Cen-

tury paid $20.6 million in commission and state premium taxes. The minimum allowed premium produced by the formula is not based on the actual $20.6 million cost. Rather, the formula produces a premium that would cover only $18.2 million of these expenses, though no one would dispute that they were actually incurred, legitimate expenses. The result is clearly confiscatory, and to the extent it is inherent in the formula, the formula is confiscatory.

The Commissioner argues that future tax benefits which 20th Century may be entiled to as a result of paying the rollback should be considered in determining whether the rollback rate is confiscatory as to 20th Century. The cases cited by the Commissioner are distinguishable. They relate to future ratemaking. Furthermore, as to *Pac. Tel. v. P.U.C.* (1965) 62 Cal.2d 634, taxes paid and disallowed there could have been avoided by filing consolidated returns. The Commissioner does not suggest that the premium taxes here were avoidable. *City and County of San Francisco v. P.U.C.* (1971) 6 Cal.3d 119, also dealt with a situation where the tax could have been legitimately avoided by filing tax returns on accelerated depreciation basis, and not doing so increased the taxes in the year in question.

This court concludes that under *Calfarm,* future tax benefits are not a proper consideration in determining whether the formula is confiscatory. Even where ratemaking is authorized, regulated rates must be set high enough to "meet all proper expenses." (*Miss. River Fund Fuel Corp. v. Federal Power Comm.* 163 F.2d 433, 451; see, also, *West Ohio Gas Co. v. Comm.* (1934) 294 U.S. 63, 83 ("Present confiscation is not atoned for by merely holding out a better life to come").)

(4) *Pro Rata Rollbacks and Cross-Subsidization.*

The formula calculates refunds for each line of insurance without regard to the 20% limit of section 1861.01,

totals these amounts, and then orders the total refunded pro rata to each line of insurance (TW 2342-46). In other words, a total company-wide refund is calculated by the formula and then applied equally to all lines regardless of the rates charged for a particular line of insurance.

As applied in the case of 20th Century, this results in a refund of more than 20% of the premiums collected in certain lines ("other liability," earthquake) to increase the refunds to insureds who bought other types of insurance, such as automobile liability (TW 2342-2346).

To illustrate, in the case of 20th Century, the formula results in 99.9% reduction of premium below the 1989 rate as to "other liability," 89.3% reduction of premium below the 1989 rate as to earthquake insurance, and only 3.9% reduction as to automobile liability. (The respective percentages vary minimally if 1987 rate levels are used—see Petitioner's Amended Memorandum of Points and Authorities for Support of Petitioner, pages 97-98.) In four of 20th Century's six lines of insurance, the additional premium is set more than 20% below November 8, 1987 rates, but the Commissioner's rollback order to 20th Century provides for an average rollback/refund of 12.2% to all. Obviously, this means that automobile line insureds' rollbacks are subsidized by premiums collected from the other lines of insurance.

The insurers contend that this violates both section 1861.01, which, they argue, provides for rollbacks based on lines of insurance, and section 1861.05(a) because requiring subsidizing of one line of insurance by another results in unfair discrimination between the two lines. (See *Blue Cross of Kansas v. Bell* (1980) 227 Kan. 426.)

With respect to section 1861.01(a), that section refers to "any coverage for a policy for automobile insurance and any other form of insurance subject to this chapter." This court concludes that this inartful language is

not intended to differentiate between lines of insurance, but is intended to provide the maximum permissible rollback to all insureds. It should be noted that section 1861.01(a) does not provide for a 20% rollback, but "at least" a 20% rollback, subject only to substantial threat of insolvency. It seems most reasonable to conclude that the voters seeking these maximum rollbacks intended pro-rata rollbacks for whatever "coverage" an insured may have had on a policy, and were not thinking of "lines of insurance" as used in the industry or elsewhere in the insurance code.

Whether the Commissioner's decision that all of 20th Century's insureds should get a 12.2% refund—though most (the auto line) were overcharged by only 3.9% under the formula (TW 2344)—violates the section 1861.05(a) prohibition against discriminatory rates is a closer question. As to future rates, such cross-subsidization may well be unfairly discriminatory. (See *Employers Liability Assurance Corp. v. Aresty* (1960) 205 N.Y.S. 2d 711.) As noted earlier, however, *Calfarm*'s application of the excessive/inadequate standard must be viewed in the context of the rollback statute which it upheld. Furthermore, in adopting Proposition 103, the voters voted for a uniform 20% rollback as well as future rates which are not unfairly discriminatory. It follows that they, at least, did not view uniform percentage refunds as unfairly discriminatory.

This court concludes that pro-rata distribution of the rollback/rebate is not inconsistent with Proposition 103 as modified by *Calfarm*. Pro-rata rollback distribution does not preclude rate determination by line.

(5) *Fair Hearing.*

20th Century contends that it was deprived of a fair hearing because the administrative law judge applied regulations which prohibited individual relief, because the administrative law judge applied erroneous statutory and

constitutional standards, because the administrative law judge relied on matters outside the record to reject its evidence, and because of various evidentiary rulings, some of which reflected application of the erroneous standards.

This court has already ruled that erroneous standards inconsistent with *Calfarm* and *Hope* and constitutional requirements were applied by the administrative law judge. 20th Century did not have to show deep hardship or insolvency and had a right to lower boundary reasonable rate of return that takes into consideration its cost of capital. Under *Calfarm,* to obtain relief from the rate set, the insurers do not have to show, as argued by the Commissioner at oral argument, that the rate "deprives me of the ability to cover my out-of-pocket costs."

Furthermore, the administrative law judge, improperly and in violation of Government Code 21515, rejected 20th Century's unrebutted expert testimony relying on findings in the RCD proceeding which were never offered in evidence or requested to be judicially noticed.

Lastly, 20th Century complains that the hearing was also rendered unfair by some of the administrative law judge's evidentiary rulings. Thus, the administrative law judge required an offer of proof based on the absolute ban on "re-litigation" in ER-19a (TW 3685). In response, 20th Century submitted extensive written testimony of Dr. Priest and Professor Stiglitz, but because Dr. Crichfield was out of the country most of the relevant time period, 20th Century was able to obtain and submit only a brief offer of proof by him (TW 3646-47 and 3693-94). Subsequently, the administrative law judge ordered Professor Stiglitz to testify before Dr. Crichfield (TW 4579-4583) and allowed him to be cross-examined for three days on matters on which Dr. Crichfield was expected to testify. Thereafter, the administrative law judge limited testimony from Dr. Crichfield and Professor Priest. Dr. Crichfield was allowed to update his initial testimony, but some of his testimony as to the use

of DCF, public utility rates, etc. was excluded as cumulative because of Professor Stiglitz's testimony. 20th Century contends that the result of the administrative law judge's various rulings on presentation of evidence was that its presentation of the case was disrupted and that its experts were prevented from testifying on issues within their primary expertise and were forced to testify on issues on which other experts were better qualified. All three experts were precluded from criticizing the RCD-2 determinations, and yet their opinions were rejected largely due to the RCD-2 findings.

Clearly, the administrative law judge has broad discretion to preclude evidence as cumulative and to require direct testimony in writing. Such evidentiary rulings only rarely raise to prejudicial error, and even more rarely serve to make a hearing unfair. By themselves, they would not render 20th Century's hearing unfair.

The cumulative effect here of applying erroneous standards and the relitigation ban of section 2646.4(e),[40] rejecting 20th Century experts' unrebutted testimony on the reasonable rate of return, and the evidentiary rulings which severely limited 20th Century's ability to present its case is to render the hearing unfair.

XIII. INTEREST

The regulation in section 2645.9(e) provide for a 10% annual rate of interest on rollbacks from May 8, 1989 to the date of payment.

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[40] Throughout the administrative law judge's decision, there are findings that issues attempted to be raised by 20th Century are "not at issue in this proceeding, having already been determined in the regulations." (TW 2905, 2907, 2919, 2921, 2922.) One is left ultimately with a sense that such evidence as was permitted was permitted pro forma, primarily for judicial review purposes.

20th Century contends that pursuant to article 15, section 1, of the California Constitution, the maximum permissible rate is 7%, and there is no authority for imposition of a 10% rate.

The Commissioner argues that the Constitution's rate does not apply to rollbacks, and that the authority for recovery of interest arises from *Calfarm*.

The Supreme Court in *Calfarm* held that "[i]f the Commissioner finds the initiative's rate or some other rate less than the insurer charged is fair and reasonable, the insurer must refund excess premiums collected with interest." See *Calfarm*, at 825.

The Commissioner's authority to require payment of interest on rollbacks thus cannot be questioned. Such authority clearly entails authority to determine the interest rate to be applied and its accrual date.

The Commissioner relies on various statutory provisions in which legislature has specified a 10% interest rate as supporting his choice of a 10% rate. Among such provisions is Insurance Code section 481.5, which provides for a 10% interest on unearned premiums. It is not unreasonable or arbitrary for the Commissioner to choose the same rate for rollbacks. This is particularly true because the insurers have had the benefit of being able to use and invest the rollback amounts and to earn interest on them pending payment of whatever rollback they are ultimately ordered to pay.

Article 15, section 1, of the Constitution deals with interest on judgments and is inapplicable to the insurer's obligation to pay interest on rollbacks because that obligation can hardly be viewed as a "judgment". Furthermore, the constitutional 7% maximum is relevant only if a higher rate of up to 10% is not provided by a statute. Code of Civil Procedure section 685.010 does provide for a 10% interest on judgments.

As to the insurer objection to the May 8, 1989 accrual date, this court concludes that choosing the midpoint of the rollback year as the beginning date for accrual of interest is not arbitrary or capricious. Arguably, the Commissioner could have chosen the beginning of the rollback year as the accrual date. The choice of midpoint is certainly fair to all.

XIV. ORDER

A. This decision shall be deemed the court's Statement of Decision, unless within 10 days any party specifies controverted issues or makes proposals not covered herein.

B. For the reasons and on the grounds set forth herein:

(1) The regulations embodying the formula and its components, sections 2644.3, 2644.12, 2644.15, 2645.3 (a), 2645.5(b) and (c), and 2645.6(b) and (c), are declared invalid and void;

(2) Section 2646.4(e), precluding relitigation, and section 2646.4(c)(8), authorizing a variance from the formula rate in cases of insolvency, are declared invalid and void;

(3) The Commissioner is enjoined from enforcing said regulations;

(4) The Commissioner's May 8, 1992 order directing 20th Century to make rollbacks set forth therein is declared invalid and is ordered set aside.

C. 20th Century's Motion to Admit Expert Rebuttal Testimony is denied as moot.

D. The matter is remanded to the Commissioner for action in accordance with this decision.

E. Counsel for 20th Century is ordered to prepare a Writ and Judgment in accordance with this decision.

F. Mr. Kent Keller, Barger and Wolen, and Paul Alexander, Heller, Ehrman, White and McAuliffe, are requested to arrange for service of copies of this decision on all parties to the JCCP 2419 proceeding who have not been served pursuant to the Clerk's Certificate of Mailing.

DATED: 2/26/93

/s/ Dzintra I. Janavs
DZINTRA I. JANAVS
Judge of the Superior Court

APPENDIX D

[Filed Sep. 29, 1994]

IN THE SUPREME COURT
OF THE STATE OF CALIFORNIA
IN BANK

20TH CENTURY INSURANCE COMPANY, *et al.*,
Respondents

v.

JOHN GARAMENDI AS INSURANCE COMMISSIONER, *etc.*,
Appellant

Petition for rehearing DENIED.

Opinion modified.

/s/ [Illegible]
Chief Justice

APPENDIX E

BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF CALIFORNIA

File No. REB-5173

IN THE MATTER OF THE
RATE ROLLBACK LIABILITY OF

20TH CENTURY INSURANCE COMPANY and
21ST CENTURY CASUALTY COMPANY
(20TH CENTURY GROUP),
Respondents.

PROPOSED DECISION

Before: Elizabeth D. Laporte, Administrative Law Judge

SUMMARY OF DECISION

After careful consideration of hundreds of pages of prefiled testimony and detailed exhibits as well as several weeks of live testimony, posthearing briefs and oral argument, we determine that 20th Century is obligated to rollback the rates that it charged from November 8, 1988 through November 7, 1989 by 12.203 percent, and order 20th Century to refund that amount to policyholders.[1]

The issues raised in this matter and addressed in this Decision can be divided into two broad categories. The first set of issues are "Technical Issues," which generally concern the proper interpretation of the Commissioner's

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[1] As used in this decision, "20th Century" and "Respondent" refer to 20th Century Insurance Company and 21st Century Insurance Company (20th Century Group).

rollback regulations [2] as applied to 20th Century and the correct data to which the formulas specified in the regulations should be applied. The second set of issues are "Statutory and Constitutional Issues," which concern 20th Century's challenge to the regulations as applied in this rollback proceeding as unconstitutional and contrary to Proposition 103. Our determinations on these issues are summarized here and addressed in much greater detail below in the section entitled "Discussion" and in our "Findings of Fact and Conclusions of Law."

Technical Issues

We accept 20th Century's proposal to adjust its original allocation of its expenses on its 1989 books to reduce its Unallocated Loss Adjustment Expenses ("ULAE") and correspondingly increase its Allocated Loss Adjustment Expenses ("ALAE"). We allocate the amount removed from ULAE to ALAE based on 95 percent to Automobile Liability and 5 percent to Homeowners. This adjustment is appropriate because although 20th Century originally reported as ULAE most of the expenses of its in-house Legal Department and fraud investigation, as well as claims-specific expenses paid on an aggregate basis known as "bulk billings," such expenses are properly classified as ALAE and are generally reported as such by other insurers.

We reject Respondent's challenge to the regulations' trimodal efficiency standards which set a more stringent standard for direct writers (i.e., insurers who sell and service policies without agents) than for insurers using captive or independent agents. The standards are based on a significant difference in the cost structure and the nature of service delivery between the different systems.

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[2] Title 10, California Code of Regulations, Subchapter 4.8, § 2641.1 *et seq.* ("The regulations").

We also reject Respondent's challenge to the regulations' formula for computing allowable fixed expenses based in part on actual losses. The use of actual losses benefits insurers who suffered high losses, thereby mitigating the harshness of unexpectedly severe losses, and avoids the speculation inherent in use of expected losses. Moreover, our decision to allow combining of automobile lines for purposes of the efficiency standard largely moots Respondent's objections to the trimodal efficiency standards and their emphasis on actual losses.

We accept 20th Century's proposal to combine its Private Passenger Automobile Liability and Physical Damage lines for purposes of applying the efficiency standards. This adjustment reduces 20th Century's efficiency standard disallowance. We make this adjustment because 20th Century presented persuasive evidence showing: the almost complete overlap between customers of the two lines; the fact that the mandatory coverage (Auto Liability) was the low priced line and thus did not subsidize the optional coverage; and the identity of personnel and departments within 20th Century marketing the two lines, based on the identical application. However, we reject Respondent's proposal to combine the lines related to Homeowners, since the same unusual set of factors is not present.

We determine that the regulations require use of direct ratemaking, i.e., direct premiums and losses, rather than net ratemaking as Respondent advocates. The latter would reduce premiums taken into account by the net amount of premiums paid by Respondent to purchase reinsurance. The regulations appropriately adopt a consistent accounting basis, and the choice of direct ratemaking as that basis is proper. It is used by the industry generally and Respondent in particular. While it disfavors insurers who had the good fortune to enjoy little or no losses in their reinsured lines in 1989 and thus did not receive payments for losses from their reinsurers, it favors the in-

surers who were hit hardest by losses. This is particularly significant for the rollback year since many insurers suffered large losses due to the Loma Prieta earthquake in Northern California, which Respondent escaped due to its concentration in Southern California. Direct ratemaking also avoids the problem that net ratemaking would pose due to the fact that reinsurance is not subject to Proposition 103. We find that the overall result of 20th Century's rollback based on direct ratemaking is not confiscatory.

We also reject Respondent's objections to use of its actual leverage ratio (i.e., premium to surplus ratio), rather than an imputed ratio as it urges, as an unjustifiable request to earn a profit on capital that it did not have, as well as an attempt to relitigate a matter previously decided in the regulations and generic determinations.

We determine that the state premium tax is properly calculated consistent with the regulations based on earned premiums since the regulations adopt "earned/incurred" as the accounting basis. This method is generally more appropriate, as well as more favorable to insurers overall.

We conclude that application of the rollback percentage to written premiums is proper since Proposition 103 requires the reduction of the prices actually charged to consumers, i.e., written rather than earned premiums.

We determine that the disallowance for bad faith judgments should apply to the award of compensatory damages in the 1989 trial judgment against 20th Century which has been affirmed on appeal, and associated 1989 ALAE. We do not disallow the 1989 ALAE associated with the 1990 trial judgment in a second case because all bad faith claims in that case are still on appeal.

Statutory and Constitutional Issues

20th Century raised a series of interrelated statutory and constitutional challenges to the application of the regulations to its rollback determination. 20th Century and

the Department of Insurance ("the Department") urged us to rule on those challenges in this proceeding, as did intervenor Allstate, and no intervenor objected to our doing so. On the threshold issue of our authority to consider such issues, we conclude that under *Calfarm Insurance Co. v. Deukmejian* (1989) 48 Cal.3d 805, 258 Cal.Rptr. 161 ("*Calfarm*"), the Commissioner is to determine for the rollback year whether and if so what higher rate than the statutory one is constitutionally required. We conclude that we have the authority to interpret existing law in the course of discharging this duty and to consider evidence offered before us in light of constitutional standards. However, in exercising this authority here, we note that almost all of 20th Century's evidence on statutory and constitutional issues came in without any objection that it was irrelevant under the regulations or improper relitigation, so we did not need to resolve such issues.

We determine that under Proposition 103 as modified by *Calfarm*, the standard which governs rollback year rates is the minimum nonconfiscatory rate of return, and that Insurance Code section 1861.05(b) is not to the contrary. This standard, derived from *Federal Power Comm'n v. Hope Natural Gas Co.* (1944) 320 U.S. 591, 64 S.Ct. 281 ("*Hope*"), and its progeny, turns on the result rather than the methodology used and permits stringent limitations on insurers' rate of return provided that the rate does not fall below the wide zone of reasonableness.

We conclude that 20th Century failed to show that the 10 percent rate of return established by the regulations is confiscatory as applied to it. Under cases such as *Permian Basin Area Rate Cases* (1968) 390 U.S. 747, 88 S.Ct. 1344 ("*Permian*"), regulators may rely on average industry data and need not individually determine a company's specific rate of return, absent a showing of deep financial hardship and serious impediment to successful

operation. 20th Century did not make such a showing. Moreover, its evidence was not directed to the lower end of the zone of reasonableness, but rather to the optimal prospective rate of return based on hypothetical investor expectations.

We further conclude that Respondent's attack on the regulations' use of rate of return rather than "price caps" is essentially a policy argument which would have us ignore *Calfarm*'s emphasis on rate of return and Proposition 103's call for reduction of rates industry-wide. Voters evidently believed that the property-casualty insurance marketplace was fundamentally flawed from top to bottom. Further, the Constitution does not forbid reducing profits below those that can be obtained in a competitive marketplace. We also find unpersuasive Respondent's evidence that the market was in a robustly healthy state of competition for several reasons, including flaws in its use of market concentration indices, the longstanding federal antitrust exemption and the exemption from state antitrust laws for ratemaking activities prior to Proposition 103.

We find that 20th Century failed to establish that it is entitled to a higher rate of return than that provided by the regulations. In an effort to prove that it had a higher cost of capital, it relied on econometric models which the Commissioner has previously considered, found unreliable, and rejected in favor of the use of actual historical industry rate of return data, for reasons explained in the RCD-2 decision.[3] Respondent's evidence did not overcome these deficiences. To the contrary, its economic evidence suffered from inconsistencies, unsubstantiated and self-serving assumptions which drove the conclusions, and implausible extreme positions, including advocacy of rates of

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[3] ***In the Matter of the Determination of Rate of Return, Leverage Factor, and Projected Yield for 1989 Rate Calculations*** **(August 14, 1991) ("the RCD-2 Decision").**

return ranging as high as 33 percent to 99 percent as constitutionally required.

We also conclude that the expense disallowances pursuant to the regulations neither deprive Respondent of substantive due process by their alleged retroactivity nor constitute an unconstitutional confiscatory "taking." The regulations are not properly characterized as retroactive in the sense required by the cases, since insurers were forewarned by the passage of Proposition 103 (and earlier by the campaign leading up to it) that their rates stood to be reduced. Moreover, even if the regulations were so characterized, they still pass constitutional muster because the rollback was forseeable (indeed, insurers were forewarned of the possibility of an even higher rollback of 20 percent), and it is not so harsh and wholly unexpected as to violate due process. Even if Respondent had a vested right (which it did not), the requirements under California and federal law for a valid retroactive law, even one which impairs vested rights, are met here, especially given the significant interest in enforcing the democratically enacted initiative. Further, the disallowance of expenditures that were prudent when made because they later turned out not be "used and useful" is not confiscatory. Also, the Commissioner knew when he set the 10 percent rate of return that certain expenses would be disallowed and found it to be nonconfiscatory in conjunction with such disallowances.

Respondent's attempt to find a First Amendment violation in the disallowance of expenses for political contributions, lobbying and institutional advertising also fails. The requirement that shareholders rather than policyholders pay such expenses is hardly an unconstitutional penalty on speech. A similar requirement by the California Public Utilities Commission has long been found valid. Nor is Respondent's right to equal protection violated either by this legitimate regulation of insurers under the Commissioner's jurisdiction, or by the trimodal efficiency standard

which is a legitimate classification rationally related to a legitimate purpose.

We also reject Respondent's claim that the rollback violates Proposition 103 by purportedly exceeding 20 percent in some lines. Our order uniformly rolls back rates in each line by 12.203 percent. Respondent's argument that investment income should be ignored in the calculation of its rate of return is a transparent attempt at relitigation of an issue correctly resolved by the regulations.

Finally, we conclude that the Commissioner has the authority as recognized in *Calfarm* to issue the regulations in the exercise of his discretion to adopt rules implementing Proposition 103. The regulations avoid the administrative gridlock that would result from readjudicating over and over hundreds of issues that affect multiple insurers in lengthy hearings that would yield inconsistent results—*if* they ever yielded any result at all. At the same time, the regulations incorporate multiple company-specific factors into the rollback formula, and then are applied in individual adjudicatory hearings. The company-specific hearings allow further tailoring to a company's situation, such as the ULAE/ALAE reallocation that reduced Respondent's rollback here.

In conclusion, we note that while Respondent and others may disagree with our decision here and continue to question the wisdom of Proposition 103, the voters of this state chose in 1988 to adopt a new approach to insurance regulation to address the pressing problems of affordability and availability in the manner they saw fit. *Calfarm* did not overturn the rollback provision but only modified it to allow relief to the extent necessary to avoid confiscatory rates.

We are entrusted with the solemn responsibility of carrying out the voters' charge, consistent with constitutional limitations. The Constitution does not act as a rigid straightjacket on the implementation of Proposition 103,

as Respondent would have it. Justice Brandeis' caution against unduly restrictive interpretations of the Constitution still applies today:

> "To stay experimentation in things social and economic is a grave responsibility. Denial of the right to experiment may be fraught with serious consequences to the Nation. It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country. . . . we must be ever on our guard, lest we erect our prejudices into legal principles." (*New State Ice Co. v. Liebmann* (1932) 285 U.S. 262, 311, 52 S.Ct. 371 [Brandeis, J., dissenting].)

On the law and the evidence in this proceeding, Respondent's attempt to transpose a failed political argument into a successful constitutional challenge fails. Having lost the electoral campaign on Proposition 103, Respondent elected not to roll back its rates voluntarily but to challenge its rollback in the administrative proceedings and in court. The recent observation of the United States Supreme Court regarding a similar gamble is apt:

> "In sum, petitioners knew they were taking a risk in reducing benefits to their workers, but they took their chances with their interpretation of the 1981 law. Having now lost the battle in the Michigan Legislature, petitioners wished to continue the war in court. Losing a political skirmish, however, in itself creates no ground for constitutional relief." (*General Motors Corp. v. Romein, supra,* 503 U.S. ——, 112 S.Ct. 1105, 1112, 1992 U.S. LEXIS 1535.

PROCEDURAL BACKGROUND

20th Century Group consists of 20th Century Insurance Company and 21st Century Casualty Company, which are wholly owned subsidiaries of 20th Century Industries, all headquartered in Woodland Hills, California. 20th Century Industries is a publicly held company, which was first listed on the NASDAQ exchange in 1986. Currently, its stock is also traded on the New York Stock Exchange. 20th Century Industries is not engaged in any business other than property/casualty insurance.

Since at least 1983, Respondent has had two principal types of business: private passenger automobile insurance (which includes Automobile Liability and Physical Damage coverages) and homeowners insurance (which includes basic Homeowners, Earthquake, and scheduled personal property or Inland Marine coverages). In addition, since 1988, Respondent has offered a personal excess liability policy. Throughout most of its history including the 1980's and 1990's to date, Respondent has experienced substantial growth in premiums written and homes and cars insured.

This proceeding was conducted pursuant to title 10, chapter 5, subchapter 4.8 of the California Code of Regulations to determine the rollback obligation, if any, of 20th Century. On October 16, 1991, the Insurance Commissioner of the State of California ("the Commissioner") issued an Order to Show Cause and Notice of Hearing directing 20th Century to refund to its policyholders 13.3378 percent of the premiums collected on policies issued or renewed between November 8, 1988 and November 8, 1989, plus interest thereon at 10 percent per annum, or in the alternative, to show cause why it should not be required to do so. Attached to the Order to Show Cause were calculation sheets based upon financial information reported by 20th Century to the Department in its financial statements for 1989. 20th Century duly

served its Notice of Defense and Answer asserting its intention not to make the specified refunds and denying the material allegations of the Order to Show Cause.

The matter was set for hearing before Administrative Law Judge Elizabeth D. Laporte. Voter Revolt, Independent Agents and Brokers of California and Western Association of Insurance Brokers ("IIABC/WAIB"), and Allstate Insurance Group ("Allstate") filed petitions to intervene which were granted by the Administrative Law Judge. Allstate elected to participate through briefing. IIABC/WAIB decided to limit its participation because 20th Century generally does not use agents.

Prehearing conferences were held on October 24, 1991 and December 28, 1991. In accordance with the Notice of Hearing and prehearing conference orders, direct testimony and accompanying exhibits were prefiled in writing by Respondent and by the Department. Evidentiary hearings at which oral testimony was heard and additional exhibits introduced were commenced on December 16, 1991 and completed on February 28, 1992. The parties filed posthearing opening, reply and supplemental briefs and oral argument was held before the Administrative Law Judge.

DISCUSSION

I. TECHNICAL ISSUES REGARDING THE IMPLEMENTATION OF THE COMMISSIONER'S ROLLBACK REGULATIONS

A. *The Reallocation of Expenses Originally Reported as ULAE to ALAE*

20th Century presented evidence that it was disadvantaged by its reporting of certain rollback year expenses as ULAE which could properly have been reported as ALAE. ALAE are expenses "charged against," i.e., related to, individual claims files, whereas ULAE are in the nature of general overhead expenses not related to par-

ticular claims files. Insurers must file annual reports known as Insurance Expense Exhibits listing expenses in each of these categories. Under the regulations, ULAE are subject to the efficiency standards, which can result in disallowance of expenses above the standard, whereas ALAE are not subject to the efficiency standards.

20th Century urged reallocation from ULAE to ALAE of certain of its 1989 expenses in the following categories: (a) the costs of its in-house Legal department, which performed claims-related litigation defense work; (b) the costs of its in-house Special Investigative Unit ("SIU"), which investigated fraudulent insurance claims; and (c) expenses known as "bulk billings" which are incurred in association with individual claims files but paid to vendors in lump sums by its Accounting Department for convenience and efficiency. Respondent pointed out that many of its competitors contract out similar legal and investigative work and properly report these three types of expenses as ALAE, since they are claims-related. In the absence of any regulatory consequences to refining its allocations between ULAE and ALAE, 20th Century had chosen to report these expenses as ULAE rather than develop a more detailed tracking system.

In support of its position, 20th Century presented testimony and exhibits sponsored by its Vice President, Chief Financial Officer and Chief Actuary, Mr. Petit, as well as testimony by its General Counsel, Mr. Bollington, and by its Assistant Vice President, Mr. Voss, who was in charge of the SIU in 1989. Mr. Petit proposed specific reallocations based on detailed analysis of rollback year expenditures in the Legal and SIU departments and bulk billings paid that year and painstaking tracking of the original allocation of the items in the company's records. In the process of his testimony and cross-examination, responsive testimony by the Department's actuarial expert Mr. Hunter, and rebuttal testimony by Mr. Petit, Mr. Petit refined his original estimates downward somewhat, and

he and Mr. Hunter reached a consensus of opinion on the precise amounts to be removed from ULAE by line of insurance. Thus, the hearing process improved the accuracy of the reallocation from the original positions of the parties.

We were favorably impressed by both Mr. Petit's and Mr. Hunter's reasonable and fair-minded approach in addressing this issue and achieving agreement on most of its aspects, and by Mr. Petit's careful use of historical business records of 20th Century rather than simply documents created afresh for the purpose of this hearing. Mr. Petit was generally a credible witness, although in some instances, such as his recommendation as to how items removed from ULAE should be redistributed among lines in ALAE, his opinions were unduly colored by his desire as a top company official to minimize 20th Century's rollback obligation. Moreover, the data that he presented on the ULAE/ALAE issue was prepared contemporaneously with 20th Century's annual report and was reliable.[4]

Voter Revolt does not object that the reallocation agreed to by Hunter is inaccurate, and indeed the evidence supported its accuracy. Voter Revolt does, however, object to any reallocation based on data not publicly reported by Respondent in their 1989 annual report. (VROB at 18-23.)[5] Voter Revolt is concerned that per-

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[4] While in this proceeding nearly all of the disputed issues regarding the reallocation of *ULAE* to *ALAE* were resolved during the hearing, agreement was reached only after Respondent was able to make a convincing showing why such reallocation was justified. Since similar issues may arise in future proceedings, the Findings of Fact and Conclusions of Law set forth a detailed account of how these issues were actually resolved. The Department's and Respondent's achievement of agreement on almost all of the aspects of this issue after exchanges of information and analyses may point the way to resolution of similar issues by negotiation in advance of hearings for other companies.

[5] As used in this decision, "ROB" refers to Respondent's Post-hearing Opening Brief, "DOB" refers to the Department's "VROB"

mitting such reallocations will open the door to insurers proposing corrections to publicly reported data based on non-public company records to which only they have ready access, which will lower rollbacks, while equally supportable corrections which would raise rollbacks will not be proposed because as a practical matter the Department and consumer groups will be unable to discover the errors. It fears that this process will unfairly bias rollbacks downwards—a form of regulatory adverse selection. (*Idem.*)

While Voter Revolt's concern is legitimate, in this instance the use of contemporaneous data not prepared for the purpose of this hearing and subjected to careful review by the Department's expert provides adequate assurance that the proposed reallocation is legitimate.[6] As Voter Revolt acknowledges, use of such historical data is consistent with section 2645.2(d) of the regulations as reasonably interpreted by the Department and 20th Century. Although Voter Revolt notes that it can also conceive of an alternative, more narrow interpretation (VROB at 18), we find that the use of this data is proper

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refers to Voter Revolt's, and "AOB" refers to Allstate's. Similarly, the Posthearing Reply Briefs are designated by "RRB", "DRB," "VRRB," and "ARB" for the Respondent's, the Department's, Voter Revolt's and Allstate's, respectively. "RT" refers to Reporter's Transcript; the number immediately following RT refers to the volume; "am," "pm" or "night" following the volume number refers to the morning, afternoon or night session within that volume, and the final number refers to the page(s) of the transcript. Exhibits introduced at the hearing are designated Res-1, Res-2, etc., for Respondent's exhibits; CDI-1, CDI-2, etc. for the Department's exhibits; and VR-1, VR-2, etc., for Voter Revolt's exhibits. Exhibits introduced after the hearing by Joint Motion (to which Respondent and the Department stipulated and the intervenors did not object) are designated ALJ-1, ALJ-2, etc.

[6] The opinion of the Department's expert, Mr. Hunter, is entitled to great weight in view of his very impressive credentials in insurance regulation and ratemaking and his forthright demeanor throughout the hearing.

under the regulations. Further, as addressed below, Voter Revolt's concern is more compelling with respect to future ratemaking, since insurers are now on notice of the need for accurate reporting. Finally, while we need not reach the issue pressed by Voter Revolt (VROB at 24-27) of whether to adopt a general "reasonableness" test in all cases in order to assure that reallocations that may be proposed by other insurers promote efficiency, the testimony was undisputed that in this case 20th Century's Legal department, SIU and bulk billings improved its efficiency, to consumers' benefit. (RT 1 pm at 156-57; RT 1 am at 42; RT 2 am at 55-56.)

Only one limited issue regarding the precise ULAE/ALAE reallocation remains in dispute between the Department and Respondent after the hearing: having agreed on the amounts to be removed from the different lines of insurance in ULAE, 20th Century and the Department disagreed as to how those amounts should be reallocated by line of insurance in ALAE. 20th Century proposed that the same proportions by which the expenses to be transferred had originally been distributed in ULAE among the different lines of insurance should be used to distribute them among lines in ALAE. However, Petit admitted that the company's original methodology for allocating these expenses by line in ULAE—done before his time—was distorted, and he did not endorse it. (RT 11 am at 39-40.) Respondent concedes in its Posthearing Brief that "further analysis might suggest that a different allocation of legal, SIU and bulk billing expenses to ULAE could have been made in 1989," but suggests (rather weakly) that "[T]here is no good reason" not to use the same flawed method. (ROB at 8.) While Respondent claims in its reply brief that this method "is a better representation of what the company would have done if it had made the allocations in 1989" (RRB at 45-46), this is pure speculation since the company deliberately chose not to make such allocations in 1989.

The Department proposed instead that the expenses should be reallocated to ALAE on the basis of 95% to the Automobile Liability Line of insurance and 5% to the Homeowner's line, as its expert Hunter recommended. (RT 12 am at 63; RT 12 pm at 107.) Hunter's recommendation was supported by the testimony of 20th Century's witnesses. Bollington testified that over 95% of legal expenses were attributable to Auto Liability (RT 1 pm at 143), which is not surprising in view of the fact that legal defense costs are usually incurred in liability lines. Voss emphasized the SIU's work in detecting auto liability fraud against 20th Century's insureds. (RT 1 am at 36-41.) Petit testified that bulk billings include items like medical examinations and records photocopying, photographs and other items of the type usually related to automobile liability claims, although no percentage was given. (RT 2 pm at 106-08.)

Based on the evidence, the Department's proposed allocation of expenses within ALAE is more appropriate. The lengthy exercise of reallocating certain expenses from ULAE to ALAE is designed to correct the allocation in 20th Century's original Insurance Expense Exhibit so that it more accurately reflects the proportion of expenses actually allocable to particular claim files by insurance line. While it makes sense to remove the expenses from ULAE in the same way that they were originally distributed in order to correct the distortion and begin with a clean slate to allocate these expenses to ALAE, it does not follow that the same flawed method by which the expenses were originally distributed among lines in ULAE should be used to distribute them among lines in ALAE.

The parties also dispute what approach to the allocation of Legal department, SIU and bulk billing expenses should be adopted for prior approval rate making. The Department seeks an order that 20th Century be required henceforth to account contemporaneously for personnel costs of the Legal department and the SIU in a

more detailed manner revealing the proper ULAE/ALAE split, and to maintain its bulk billing records in a manner enabling a clear determination of the proper allocation. 20th Century opposes the Commissioner mandating any specific expense tracking procedures as an unnecessary expenditure of time and money, noting that it has previously rejected detailed time-keeping for the Legal and SIU departments as not cost-effective.

The Commissioner shares 20th Century's concern about avoiding unnecessary expenses associated with an unnecessarily elaborate reporting system. However, the Commissioner must also consider the need to avoid the expense and potential for inaccuracy and disparate treatment of insurers and policyholders inherent in post-hoc reconstruction in lieu of proper contemporaneous allocations between ULAE and ALAE. The Commissioner has accepted 20th Century's proposal for a reallocation of ULAE to ALAE in the rollback year in light of the evidence discussed above and its representation that at the time it had no reason to refine its allocation more carefully. However, that rationale does not apply to the future.

On balance, the Commissioner determines that an adequate system for proper classification between ALAE and ULAE of the expenses of the Legal department, SIU and bulk billings should be required for the future, which permits reasonably accurate allocation by line of insurance. However, that system need not be a detailed, to-the-tenth-of-an-hour timekeeping system of the nature often employed in private law firms engaged in litigation. At oral argument, 20th Century agreed that the Department's proposal that bulk billing records be kept in such a manner that the Department can clearly determine whether and how the allocated claims adjusted expenses were allocated was workable and appropriate. (RT 15 at 12-13.) The Department acknowledged, despite the more restrictive approach it advocated in the portion of its

original proposed finding number 52 relating to the Legal department's and SIU's recordkeeping, that such records need only be reasonably contemporaneous and that while individual claim-by-claim records would be preferable, allocation in bulk into two categories, claim specific and non-claim specific, would suffice. (*Id.* at 9-10.)

At the Administrative Law Judge's suggestion, the Department filed an alternative proposed finding number 52 as to Legal and SIU recordkeeping which only requires at least weekly recordkeeping by employees and tracking time by line in two broad categories, claim-specific and non-claim-specific, rather than case-by-case. (Department's Proposed Alternate Finding on Loss Adjustment Expense Record-keeping, filed on April 2, 1992.) While Respondent also objects to the Department's less restrictive proposed method in its own "Proposed Supplemental Finding on ALAE Record Keeping," filed on April 9, 1992, this method strikes a reasonable balance. On the one hand, it affords 20th Century reasonble flexibility in its recordkeeping and imposes relatively little administrative burden. It is far less burdensome, for example, than the detailed time-keeping—often to the tenth of an hour—by case and by task that attorneys in private firms commonly use. On the other hand, it is designed to avoid inaccurate inflation of time classified as ALAE as opposed to ULAE, which we find (without in any way intending to impugn the honesty of 20th Century employees, which we have no reason to doubt) would be the natural human tendency if only non-ALAE time were required to be reported, given the imbalance in effort and the inertia factor. The Department's revised proposal effects a reasonable balance between these competing goals.

B. *The Efficiency Standards*

1. *The Trimodal Structure of the Efficiency Standards*

The regulations adopt a trimodal set of efficiency standards, with separate standards for each of the three classes of insurers: direct writers like 20th Century which do not use agents, captive agency companies and independent agency companies. (§ 2645.5.) Direct writers, who employ the lowest cost distribution system, are subject to stricter efficiency standards than companies that use captive or independent agents. Respondents challenged the fairness of this trimodal approach.

This issue was litigated and determined in the rulemaking and generic proceedings, and may not be relitigated in this proceeding. (Regulations, § 2646.4(e).) Respondents' quarrel is with the policy choice made by the Insurance Commissioner to whom such choices are entrusted. Moreover, it is undisputed that 20th Century, like other direct writers, enjoys lower costs because it does not have to pay agents or maintain field offices to sell policies. (RT 2 night at 259; RT 2 pm at 144-45.) At the same time, to the extent that agents provide services not available to customers of direct writers, insurers using the higher-cost agency distribution systems provide different services which may be valued by consumers who pay for them. (*Id.*)[7] The regulations take these differences into account by using a three- tiered efficiency standard.

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[7] Mr. Petit presented an example in Res-87 designed to illustrate that a company could operate at the efficiency-standard percentage of expenses to premium and yet have an expense disallowance under the efficiency standard. However, cross-examination revealed that the example was skewed by the hypothetical company's extraordinarily high rate of return (approximately 50 percent when investment income and leverage were taken into account), whose reduction under a rollback would also result in a reduction of permitted expenses by eliminating overhead that had been associated with the overcharge. When the example was adjusted to provide a profit margin consistent with the Regulations, there was no disallowance. (CDI-159.)

20th Century makes the further argument that the trimodal standard is particularly inappropriate when applied retrospectively to determine its rollback obligation, because it can no longer attempt to adjust its expenses to meet the standard and because consumers are no longer exercising a choice of distribution system. (ROB at 24-25.) These arguments are not persuasive. There is no reason to believe that Respondent would have radically changed its market niche to adopt a different distribution system under which it would have had higher expenses and might therefore have fared no better. To the extent that 20th Century is simply arguing against any expense disallowance for the rollback year based on an alleged lack of notice, Proposition 103 put insurers on notice that they could well face rollbacks. Further, the regulations recognize that consumers did exercise a choice among systems in 1989. Adoption of Respondent's position would result in penalizing agent-distribution insurers for offering that choice by subjecting them to a standard based in large measure on companies with lower costs because they had no agents.

Respondent's constitutional challenge to the trimodal standard as violating its equal protection rights is addressed below, in Section III.E.

2. *The Formula for Computing Allowable Fixed Expenses*

20th Century also argues that the regulations' ratemaking formula for maximum permitted expenses is "irrational" because it creates excessive disallowances in lines of insurance (especially low frequency, high severity lines) where its actual losses turned out to be lower than expected. The Department responds, correctly, that the formula is not solely a function of losses (*see* regulations, § 2644.12(a)), but acknowledges that losses are a major component because the nature of the insurance business is to indemnify losses. It explains that the formula is not

simply based on a percentage of actual premiums but is instead based on a percentage of allowable premiums in order to avoid higher expense allowances for an otherwise similarly situated company which charged excessive premiums.

Because of the important role of losses, the formula can result in expense disallowances in lines where losses were significantly lower than predicted. As 20th Century points out, this effect is marked in its Earthquake line, where it had low losses in 1989—a year when most companies writing significant Earthquake insurance had high losses due to the Loma Prieta earthquake in Northern California. However, the regulations are symmetrical in their treatment of deviations from expected losses. Although insurers who enjoy very low losses compared to expectations (and thus enjoy a higher profit margin than expected) are allowed lower expenses, insurers who suffer unexpectedly high losses—such as most insurers who wrote earthquake insurance in 1989—may pass through higher expenses. This approach mitigates the harshness of unexpectedly large losses. On the other hand, the use of actual losses rather than expected losses only denies compensation for losses that did not occur to insurers who were lucky in having unexpectedly low losses.

Given the proper goal of impartial, uniform treatment of insurers (and their policyholders) under the regulations, the approach adopted by the regulations of using incurred losses is a rational one. Furthermore, the use of actual incurred losses for a period now passed rather than hypothetical expected losses also avoid the inherent speculativeness of expected losses, which cannot be avoided in setting future rates but is avoidable here. Finally, we note that 20th Century's marginal cost of writing Earthquake insurance was low since it was in large part an "add-on" cost to writing homeowners policies. (Rt. 3 am at 62-63.)

In any case, as set forth below, the Commissioner has adopted 20th Century's proposal for combining the automobile lines for purposes of applying the efficiency standards, where most of the efficiency standards disallowance would otherwise occur. Respondent itself acknowledges that combining lines resolves its objections to the efficiency standards' trimodal nature and heavy emphasis on losses. (ROB at 28:17-20; RRB at 55:4-7.)[8] Combining the automobile lines also substantially alleviates 20th Century's argument that the efficiency standards yield an anomalous result in disallowing expenses that it incurred even though it was generally an efficient company.

C. *Combining of Related Lines for Efficiency Standard Calculations*

Under the Department's original calculation of Respondent's rollback liability, Respondent had a substantial efficiency standard disallowance in Private Passenger Automobile Physical Damage insurance even though its expenses in Private Passenger Auto Liability were well below what the efficiency standard would permit it to charge in rates. The reallocation of some expenses from ULAE to ALAE (discussed above) significantly reduces the original $6.4 million disallowance in Physical Damage expenses that the Department initially calculated. However, even after the ULAE/ALAE adjustment, Auto Physical Damage still exceeds the standard by $2.9 million,

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[8] While Respondent urges that both the auto lines (Liability and Physical Damage) and what it terms the homeowners lines (Homeowners, Earthquake and Other Liability) be combined, combining the auto lines alone as this decision does achieves most of the reduction in rollback liability that is achievable by combining lines. (*Compare, e.g.*, ALJ-1 [no lines combined, rollback obligation of 12.6899 percent, estimated refund of $81,432,339], ALJ-2 [auto lines only combined, rollback obligation of 12.2139 percent, estimated refund of $78,377,808] and ALJ-3 [both auto and "homeowner's" lines combined, rollback obligation of 12.1945 percent, estimated refund of $78,253,129].)

while Auto Liability could have been priced $13.4 million higher without triggering the efficiency standard. (Compare CDI-168 [Exh. 5 thereto, cols. 2 and 4] with CDI-105 [Exh. 5 thereto, cols. 2 and 4]; see Petit Rebuttal at 17-18.)

Respondent argued, based on testimony by Petit and Mr. Curley, its President and Chief Operating Officer, that the two automobile lines should be combined, thereby eliminating any efficiency disallowance in automobile insurance. The evidence showed that 85% of all vehicles insured by 20th Century carry Physical Damage coverage in addition to Auto Liability coverage and that the proportion of policyholders who buy both coverages is probably over 90 percent, since on average 1.6 vehicles are insured per policy and often policyholders with more than one insured vehicle drop Physical Damage coverage on their older vehicle only. (RT 10 am at 29.) Further, 20th Century marketed Physical Damage insurance simultaneously with Auto Liability based on the same auto insurance application. (Petit Rebuttal at 17; Res-82.) Accordingly, the group of consumers who purchased the "overpriced" line in which Respondent exceeded the efficiency standard is entirely contained within the population purchasing the "underpriced" line where Respondent was below the standard. Indeed, the population purchasing two lines is almost identical, given the overlap of approximately 90 percent or more.

The testimony also established that the line containing a mandatory coverage—Automobile Liability (see Cal. Vehicle Code §§ 16430, 16431, 16451, 16500)—was the "underpriced" line, and hence did not subsidize the optional coverage for Physical Damage. Further, the same personnel and departments at 20th Century were responsible for selling Auto Liability and Physical Damage, without regard to line of insurance, so the two lines drawn on the same cost components. (RT 10 am at 29; RES-82.)

In opposition to Respondent's proposal to combine auto lines for purposes of the efficiency standard, the Depart-

ment made several arguments. First, its expert Hunter testified that the problem of the Auto Liability line easily meeting the efficiency standard whereas the Physical Damage line did not arose because 20th Century mispriced the two products by setting the premium for the Auto Liability line low relative to its losses while setting the premium for Physical Damage high relative to its losses. (Hunter Direct at 23.) Hunter based this conclusion on Petit's testimony about the pricing discrepancy, which Petit stated had received a low priority at the time when auto prices were set for the rollback year because the discrepancy did not have any regulatory consequences. (Petit Direct at 16.) Hunter criticized this mispricing as causing purchasers of Physical Damage coverage to pick up a share of the expenses actually attributable to Auto Liability, harming the marketplace by making comparison shopping even more difficult for consumers and potentially disadvantaging competitors. (Hunter Direct at 23.) However, on cross-examination Hunter acknowledged that all consumers purchasing the higher-priced Physical Damage line benefited because they also purchased the lower-priced Auto Liability line, so they were not injured by the cross-subsidy between lines. (RT 12 pm at 171-72.)

The disparity in expense levels relative to prices between the two auto lines resulted from 20th Century's deliberate decision to lower the price of Auto Liability coverage relative to its losses and relative to the price of Physical Damage coverage. 20th Century's President Curley admitted that 20th Century deliberately mispriced these two lines relative to their losses due to marketing considerations about the "liability crisis" and the potential effect of a price increase on purchasers of less expensive, mandatory-liability-only policies. (RT 10 am at 57-59.) 20th Century argues, however, that it should not be penalized for this decision made at a time when the mispricing did not have clear regulatory consequences.

In light of the evidence that its pricing decision was deliberate, 20th Century is less than candid in its other argument for combining lines—that the regulations unfairly penalize 20th Century for a misprediction "by happenstance" of the differences in auto loss ratios when it set the rates for the rollback year. (ROB at 30.)[9] Further, Curley acknowledged the desirability of accurate pricing so that loss ratios are similar across lines. (RT 10 am at 54, 58.) Thus, the Department's point about the desirability of accurate pricing of each line of insurance (absent an overriding public policy duly set by statute or regulation) is well-taken, and indeed Respondent's President agreed with it in principle. The Commissioner finds, however, that the goal of accurate pricing of each line (in the absence of a compelling public policy overriding it) weighs more heavily in the context of prospective ratemaking.

In its Posthearing Reply brief, the Department contended for the first time that Respondent's rationale for combining related lines was based on the faulty premise that the efficiency standard disallowance was due to inaccurate pricing. The Department argued that the efficiency standards are a function of losses and the other components of the cost of service, not the premiums charged. (DRB at 29.) However, the Department's expert did not quarrel with Petit's testimony that the efficiency standard disallowance was related to a pricing discrepancy between Auto Liability and Physical Damage. Also, in the same brief and in posthearing oral argument, the Department acknowledged that the efficiency standards

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[9] Indeed, Respondent acknowledged in its brief that ". . . in a high frequency, low severity line, such as auto physical damage, losses will not fluctuate erratically from year to year . . . there is likely to be a much higher correlation between predicted and actual losses." (ROB at 18.)

indirectly penalize mispricing by disallowing fixed expenses related to excessive premiums.[10]

20th Century's argument for combining the auto lines for purposes of the efficiency standards for the rollback year is based on special circumstances, including: the sale of the two auto lines based on the same application and drawing on the same cost components (sales personnel, overhead organization and claims unit); the almost complete overlap (over 90%) between purchases of the two lines and the 100% containment of the population purchasing the line above the efficiency standard within the population purchasing the line below the efficiency standard; the fact that the higher priced line does not contain a mandatory coverage; and the evidence that 20th Century is generally an efficient provider of auto insurance to the segment of the population that it insures.[11]

Accordingly, the Commissioner exercises his discretion to allow combining of the auto lines for application of the efficiency standards to 20th Century's rollback. The Department acknowledges that the Commissioner has the

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[10] "The function of the formula in section 2644.12 is to ensure that the efficiency standard is computed on the basis of the allowable premium, not on the basis of possible overcharges; a company should not be allowed more in rates simply because it overcharged, say, to obtain an excessive profit. . . . The regulations limit the insurer to expenses of [the applicable factor from § 2645.5(c)] percent of the *permitted earned premium.*" (DRB at 26-17 [emphasis in original].) Thus, when a premium is rolled back because of a high rate of return, allowable fixed expenses are correspondingly reduced to limit expenses to a fixed percentage of the rolled back premium. (RT 15 at 38-40.)

[11] 20th Century's ability to provide low auto insurance rates stems not only from operational efficiencies but also from selective underwriting. (*See* Res-82 [20th Century Automobile Insurance Quotation/Application, inside left page and back cover, stating that its low prices are because of its: (1) lower costs due to use of direct writing rather than agents and centralization of processing operations; and (2) selectivity in whom it insures].)

discretion under the regulations pursuant to section 2646.4 (e) to make the proposed adjustment for the related auto lines, since this issue was not fully litigated previously. (DOB at 14; RT 15 at 44.) Voter Revolt disagrees and expresses fear that to allow such an adjustment will open a Pandora's box. (VROB at 11-12.) However, we agree with the Department and Respondent that we do have such discretion. Our exercise of the discretion only in the presence of the specific factors noted above and only for the rollback year (and not for prospective rate-making when 20th Century cannot claim any lack of notice) will not lead to conflicting results among insurers.

Respondent also had a much smaller efficiency standard disallowance of $113,039 in its Earthquake and Inland Marine lines, while it could have charged slightly higher premiums in Homeowners than it did without triggering the efficiency standard. (CDI-168; Petit Rebuttal at 28.) While Respondent argued that these three lines also should be combined with each other for purposes of the efficiency standards, it presented far less evidence on this point. (*See, e.g.,* Petit Rebuttal at 17-19.) This argument is less persuasive than the argument for combining related auto lines. Unlike automobile insurance, where the overlap between purchasers of the related lines is almost complete, only 37 percent of Homeowners policyholders buy Earthquake coverage and well under 10 percent buy Inland Marine. (RT 10 am at 47-48.) Also, unlike auto, the lines related to Homeowners are not necessarily sold based on the identical application. For example, customers who wish to purchase supplemental Inland Marine coverage beyond the basic option offered in the Homeowners application cannot do so through the Homeowners application but must ask for additional information to be sent, and apparently then must complete a different application. (RT 10 am at 47; *compare* Res-82 and Res-83.) Hunter testified that more of a case could be made for combining auto lines than combining the Homeowner, Earthquake and Inland Marine lines. (RT 12 pm at

160.) Accordingly, the Commissioner will not combine the lines related to Homeowners for purposes of application of the efficiency standards.

20th Century also had a small disallowance of $6,374 in its Other Liability line (a personal umbrella liability coverage). However, Petit testified that the Other Liability line could remain separate, since he could not say whether it is properly combined with the related auto lines or with Homeowners, and Respondent's counsel conceded that the treatment of Other Liability was of very little consequence to 20th Century. (Petit Rebuttal at 19; RT 10 pm at 183; *see* RT 13 am at 87-89.) Although 20th Century later argued that this line, too, should be combined with *either* the auto lines or Homeowners, its argument is not persuasive in light of its concessions and for the reasons stated above against combining the lines related to Homeowners, which also apply even more strongly to Other Liability. (*See* Res-82 and Res-83 [auto and homeowners applications do not include Other Liability].)

D. *Computation of Rollback on Direct Basis Rather Than Net of Reinsurance Premiums and Losses Ceded*

Respondent objects to the Department's calculation of its rollback based on direct premiums and losses, rather than net premiums and losses. Under the latter approach, premiums ceded to reinsurers are subtracted from total premiums in the ratemaking formula and (as 20th Century conceded in response to Hunter's reply testimony) recoveries from reinsurers, known as ceded losses, are also subtracted. (Petit Rebuttal at 4-5; Hunter Reply at 13-14.)

20th Century ceded $5.6 million in premiums to reinsurers, net of ceding commissions that it earned from its reinsurers; its reinsurance premiums were partially offset by the $868,635 that it received in ceded incurred losses.

(Petit Rebuttal at 4; Res-6.) Almost $4.5 of the ceded premiums were in 20th Century's Earthquake line, where it experienced low losses ($629,532) and did not have any ceded incurred loss. (Res-6.) The other lines of business in which 20th Century ceded premiums to reinsurers were Homeowners, Inland Marine and Other Liability. (Petit Rebuttal at 4.) 20th Century presented testimony by Mr. Petit that the calculation of its rollback liability unfairly failed to account for the cost of its reinsurance activity by treating the company as having retained all its direct premium of $642 million even though over $5 million of that premium was ceded to reinsurers. (Petit Direct at 5-6; Rebuttal at 4.)

On cross-examination, Petit admitted that 20th Century, like the industry generally, performs its own ratemaking on a direct basis. He also acknowledged that reinsurance premiums and recoveries are properly excluded from rate calculations on a direct basis, although he added that in his view applying direct ratemaking retrospectively did not produce sufficient premium for 20th Century. (RT 1 pm at 200-01; RT 2 pm at 151.) Further, Petit candidly conceded that the Commissioner should adopt a uniform basis for ratemaking for all insurers, whether direct or net. (RT 2 pm at 151-52.) While he qualified his concession regarding the appropriateness of a uniform approach by adding that there might be circumstances justifying different treatment, notably he could not enumerate any at the time. (RT 2 pm at 151-52, 166.)

Hunter testified in reply that the Department's rollback calculations are properly and consistently performed on a direct basis, under which neither premiums ceded nor amounts received from reinsurers for losses are recognized, and opined that use of the direct basis is appropriate for rate regulation. (Hunter reply at 14-15.) He noted that the insurance consumer does not care about reinsurance transactions since the consumer pays direct, not net premium. (*Id.* at 15.) He also testified that rate regulators typically use direct premiums and losses, and

that to do otherwise might create a regulatory loophole since reinsurance rates are not regulated. (Ins. Code § 1851.)

Hunter further explained that if the Department adopted the approach urged by 20th Century of computing the rollback based on net premiums and net losses, the result would be harshest for the many companies that actually had large losses in 1989 (i.e., those who had incurred large losses in the Loma Prieta earthquake). (RT 12 am at 80-81.) Petit confirmed that these insurers benefit from direct ratemaking, which does not recognize their recoveries from reinsurers. (RT 2 pm at 154-56.) Hunter testified that even though direct ratemaking was less beneficial to 20th Century than to insurers with large losses, 20th Century was in a better financial position to absorb the effects of direct ratemaking because it enjoyed little or no losses. He also testified that its rollback obligation to Earthquake policyholders would only be approximately 13% of its $8.7 million direct premiums. (*Id* at 80.)

In accord with Hunter's testimony, the Department advocates a consistent approach to calculating all insurers' rollback obligations, and argues that the regulations properly adopted direct premiums and losses as that approach. It points out that calculating rollbacks net of reinsurance as Respondent urges would favor companies who already benefitted from unexpectedly favorable losses that year, but disfavor insurers who suffered unexpectedly bad losses, whereas using a direct basis has the opposite impact. While conceding that both direct and net ratemaking have their place, the Department argues that the regulations properly adopted the direct basis, and it should be adhered to consistently. It notes that accounting systems necessarily employ conventions, and that proper accounting requires using the same system consistently rather than varying conventions *ad hoc*, just as cash accounting methods should not be mixed up with accrual accounting.

The Department argues further that the Commissioner's choice of direct ratemaking was superior from a public policy standpoint because it favors companies with the worst loss experience and disfavors those best able to pay a higher rollback. (DOB at 8.) In fact, it is undisputed that 20th Century is very unusual in having written a non-neglible amount of Earthquake insurance (although Earthquake still represented only 1.35 percent of its premiums), yet had no recoveries from reinsurance in that line in 1989 due to its lack of exposure in Northern California where the Loma Prieta earthquake struck. Voter Revolt similarly urges that the Commissioner properly adopted a consistent system, and given that any system would benefit some insurers more than others, the Commissioner reasonably exercised his discretion in choosing the direct basis to compute rollback liability. (VROB at 29.)

The Department also points out that calculating premiums net of reinsurance would shelter insurers' premium from Proposition 103 rollbacks in proportion to the percentage of premium ceded, since reinsurance is not subject to Proposition 103. (Ins. Code § 1851(a).) This phenomenon was illustrated in Petit's cross-examination, in which he acknowledged that computing the rollback on a net basis could result in policyholders in companies who ceded their entire premium for reinsurance receiving no rollback. (RT 2 pm at 160-62.) Petit testified that although in such a case consumers would receive no rollback even if their company had no losses, they had received insurance coverage of their risks for that year in exchange for their premiums. However, this argument runs contrary to Proposition 103's mandate of a reduction in rates, which voters evidently enacted in the belief that consumers paid too much for their insurance. Similarly, Petit admitted that net ratemaking would not be appropriate for a California insurer who also provided reinsurance to another California insurer and thus re-

ceived net premiums in excess of its direct earned premium. (RT 2 pm at 164-65, 168-70.)[12]

The regulations specify that rates, including those for the rollback period, shall be computed on the basis of direct premiums. (§ 2645.9.) Respondent's argument that the regulations nonetheless do not specifically preclude the treatment of net reinsurance costs as an expense is ingenious. (RRB at 16.) However, the Department's and Voter Revolt's argument that the regulations require consistent use of direct ratemaking is more persuasive in light of the language of the regulations and the governing statute.

Proposition 103 mandated a reduction in charges to consumers for property-casualty insurance policies. (Ins. Code § 1861.01, subdivisions (a) and (d).) These charges to consumers are, of course, in the form of direct premiums, not net premiums. Therefore, calculating the rollback on a net basis departs from Proposition 103 and may be justified only if the result is unconstitutionally confiscatory under *Calfarm* and other applicable authorities.

The component of the rollback calculation related to 20th Century's Earthquake line may appear somewhat harsh when it is viewed in isolation as 20th Century urges, as if it were the final result rather than only an intermediate step in the calculation. However, 20th Century's rollback must be judged on the issue of confiscation based on the overall result. (See Section III.B.2, below.)[13] From that perspective, the impact is not confisca-

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[12] Petit testified that "maybe in that case [where an insurer had net premiums higher than direct premiums because it provided reinsurance as well as insurance] I would have to go back to direct" (RT 2 pm at 169) and "I guess I would have to remove it somehow." (*Id.* at 170.)

[13] 20th Century's argument that it might have made different choices with respect to reinsurance had it known that direct ratemaking would be adopted is not compelling under the circumstances here. Not only is this argument subject to the general objections that the Department makes to this type of "back-to-the-future" rationale (e.g., DRB at 17), reflected in the somewhat

tory. (*Calfarm*, 48 Cal.3d at 816 [" 'it is the result reached not the method employed which is controlling' " (citations omitted)].) 20th Century is a multi-line insurer whose Earthquake line accounted for only 1.35 percent of its business ($8.7 million of $641.7 million) in the rollback year, and its unrecognized reinsurance premiums on Earthquake only accounted for 0.7 percent of its business ($4.5 million of $641.7 million). (Petit Rebuttal at 4.) It admittedly suffered very low losses in its Earthquake line that year and its cost of writing that coverage was small (estimated by Mr. Hunter to be as low as five dollars per policy, see RT 3 am at 62-63), so it enjoyed a high profit in that line. In any case, calculation of the Earthquake component of the rollback is merely one of many intermediate steps to the final rollback. Contrary to 20th Century's contention, the rollback in Earthquake is not over 89%. (RRB at 66.) The final result is a uniform rollback to policyholders in each line including Earthquake of 12.203%—well under 20% in all lines. (ALJ-20; see Section III.F., below.)

Further, the Department's and Voter Revolt's argument that the regulations embody a reasonable policy choice

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surrealistic testimony of a company official that "it would have been awful scary at the time" several years ago *if* he had known then what he knows now. (RT 11 am at 48-49.) (Of course, he did know then that Proposition 103 had been enacted by the voters.) The contention also has little force on the facts here, when admittedly "the vast majority" of 20th Century's reinsurance in 1989 (about 80%) was purchased in the Earthquake line. It would have purchased earthquake reinsurance because of its heavy exposure as a California-only insurer regardless of the treatment of reinsurance in rollback calculations. (ROB at 17; RT 11 am at 33-34, 47-48.) Petit speculated that 20th Century might have dropped or lowered its much smaller amounts of reinsurance in the other lines if it had had notice of the regulations' treatment of reinsurance (RT 11 am at 47-48). However, such a decision would not have made a major difference in the rollback calculation. The ceded premiums on those lines were $1,139,913 (net of commission). These were to a large extent offset by reinsurance recoveries of $868,835. (Petit Rebuttal at 4-5.)

by the Commissioner to adopt direct ratemaking as a consistent basis for determining rollback obligations is supported by the weight of expert testimony and is persuasive. Indeed, Respondent's witness agreed that as a matter of policy the Commissioner should adopt a consistent basis for all insurers and that direct ratemaking would greatly benefit companies with large reinsured losses like those who paid claims due to the Loma Prieta earthquake. These admissions undercut the rationale for its contention that the use of direct ratemaking is unfair. Further, while 20th Century's argument that direct ratemaking is unfair because it ignores money actually paid to purchase reinsurance in 1989 has some appeal at first blush, it ignores the fact that any set of accounting rules necessarily includes conventions which in a sense deviate from actual expenditures. Indeed, 20th Century benefits from the regulations' recognition of 1989 reserves as if those amounts were actually paid, when in fact the claims covered by reserves were actually paid after 1989.

On balance, for the reasons explained above, the Commissioner's choice of direct ratemaking is reasonable and not improper as applied to 20th Century. Any other approach would impose harsher treatment on other insurers or lead to inconsistent, *ad hoc* calculations of different companies' rollback obligations.

E. *Respondent's Proposed Additions to Other Income*

Petit testified that the Department had incorrectly omitted certain (negative) income items from its calculations. (Petit Direct at 18-19.) Respondent presented adequate evidence to show the nature of those items and the propriety of charging them against income. Based on this showing, Hunter testified that the items should be included. (RT 3 am at 36-37.) Voter Revolt does not oppose these adjustments. (VROB at 23 n. 30.) Accordingly, this undisputed correction to the rollback calculation is proper.

F. *Respondent's Proposed Corrections to the Insurance Expense Exhibit*

Petit testified that 20th Century's Insurance Expense Exhibit ("IEE") which it submitted for 1989 contained several relatively small errors, consisting of negative numbers instead of zeroes for direct commission amounts in Homeowners, Inland Marine and Earthquake. (Petit Direct at 14; RT 2 am at 58-60; Res-19.) While 20th Century detected these errors prior to the hearing, in view of their minor nature it did not deem them significant enough to refile a corrected IEE. (RT 2 am at 60.) Hunter agreed that the proposed corrections were proper. (RT 3 am at 34-35.) Voter Revolt does not oppose these minor corrections. We find the evidence persuasive and allow the corrections.

G. *Respondent's Objections to the Leverage Standards*

Respondent originally contended that the rollback increased its leverage ratio (i.e., premium-to-surplus ratio) to a higher level than the Department permitted in its solvency review of Respondent. The evidence did not support this claim. In support of this contention, Respondent pointed to a letter from the Department to 21st Century asking when it would infuse the needed surplus to maintain a 3:1 premium to surplus ratio. (Petit Direct at 19 and attachments thereto.) However, the letter simply responded to Respondent's earlier letter acknowledging that the projected growth of 21st Century would require it to add capital to maintain that ratio, and that it planned to do so by transferring funds from 20th Century. (Attachments to Petit Direct.) Moreover, on cross-examination Petit admitted that the Deparment's concern was solely with 21st Century, not with group-wide surplus, and that Respondent had satisfied the Department by an inter-affiliate transfer of surplus. (RT 2 pm at 173-74.) Respondent no longer relies on this letter in its posthearing arguments.

Respondent nonetheless continues to press its attack on the regulations for not applying the same leverage approach as used in prospective ratemaking, under which rates can be disallowed for producing too high a leverage ratio as well as for producing too low a ratio. For rollback, the regulations use whichever is higher, the actual leverage ratio that the insurer had in the rollback year or a specified ratio. (§ 2645.6.) Respondent contends that for the rollback year it should be permitted to earn a profit on a higher level of surplus (i.e., lower leverage or premium-to-surplus ratio) than it actually had that year, because as a more highly leveraged company, it was riskier and therefore entitled to a higher rate of return. (*Cf.* Stiglitz Direct at 31 [with qualification of unspecified "other things being equal"].)[14]

Hunter testified persuasively that Respondent's contention boils down to an unjustifiable request to earn a profit on capital that it did not have. (Hunter Reply at 25.) In any case, Respondent's argument is really an attempt to relitigate the regulations' and generic determinations' treatment of leverage ratios for rollback calculations, contrary to the limitation on relitigation. (§ 2646.4(e).)

H. *The Computation of Premium Taxes on an Earned Premium Basis*

Written premiums are the premiums actually paid by consumers to insurers, whereas earned premiums are premiums associated with the time periods when the insurer has provided coverage and thus "earned" the premium. 20th Century contends, based on testimony by Petit, that the regulations improperly calculate state premium taxes for purposes of the rollback based on

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[14] **Respondent omits the corollary to its argument that its stockholders deserve a higher return because of the greater risk entailed by respondent's high leverage ratio: that policyholders who purchased its insurance for security and peace of mind shared in this higher risk, and probably did so involuntarily.**

earned premiums even though the taxes are paid based on written premiums. (Petit Direct at 20.) In a growing company like 20th Century, earned premiums lag behind written premiums. (*Id.* at 21.)

Hunter responded that the regulations properly account for insurance operations based on an earned incurred basis rather than a written/paid basis. (Hunter Reply at 26.) The former recognizes revenue as it is earned and liabilities as they are incurred, whereas the latter basis recognizes revenue when received and liabilities only when paid.) (*Idem.*) He testified that the two methods should not be mixed. He explained that the regulations employ the earned/incurred basis, which is more accurate for ratemaking purposes and generally favors insurers. For example, it recognizes expected losses on a policy even though the losses may not be paid until years later. (*Id.* at 27.) The premium tax rate is 2.37 cents per premium dollar, whether accounted for on an earned or written basis. He testified that the regulations use 2.37 percent as the premium-tax component of insurance costs to determine the minimum permitted earned premium, but simply recognize that cost a little later on an earned basis. (*Idem.*)

Petit testified on direct examination that if the state allows the company to adjust for the premium tax amount in essence overpaid due to the rollback reducing its premiums, the company is not harmed. (RT 2 am at 79.) On cross-examination, Petit admitted that 20th Century had not consulted tax counsel nor inquired of state tax officials as to whether the state will honor the filing of a corrected 1989 statement or a statement for the year in which the rollback is paid that would permit the company to recover the premium tax that it paid on refunded premiums. (RT 2 pm at 175.) Respondent's weak argument that it is "not clear" whether the State will allow such recovery—an argument that is not based on any evidence in the record or citation to specific law and is made essentially without explanation—does not

constitute a sufficient reason to depart from the regulations. (ROB at 41 n.1.)

I. *Implementation of the Rollback Obligaton as a Percentage of Written Premiums*

20th Century argues that the implementation of the rollback formula penalizes it because although the rollback percentage is computed using earned premiums as a base, that percentage is then applied to written premiums to yield a rollback amount. (Petit Direct at 21.) As noted above, written premiums exceed earned premiums at any given time for a growing company like 20th Century. Hunter responded that while the regulations initially determine the percentage reduction in premiums through an earned premium method (§ 2645.9 (c)), Proposition 103 requires that the ultimate rollback amount to be a percentage of premium paid on policies written during the rollback year. (Hunter Reply at 19.) (See section II.H, above, for a discussion of the reasons that the earned/incurred basis was used to calculate the rollback percentage).

20th Century correctly notes that the language of Proposition 103 requires application of the percentage reduction to written premiums, and that consistent with the statute the regulations specify that rollbacks are based on premiums paid by consumers multiplied by the refund percentage. (RRB at 42; Ins. Code § 1861.01(a); regulations, § 2646.4(e).) The interim use of earned/incurred accounting to arrive at a rollback percentage, which Hunter testified is based on sound reasons that generally operate to insurers' advantage, does not preclude or somehow render improper the application of that percentage to written premiums to determine the ultimate rollback amount as required by Proposition 103.

J. *Disallowance of Expenses for Bad Faith Judgments and Associated Loss Adjustment Expenses*

Section 2644.10(c) of the regulations states that "[B]ad faith judgments and associated allocated loss adjustment expenses," i.e., ALAE, shall not be allowed for ratemaking purposes. While 20th Century disputes the other disallowances in section 2644.10 as discussed below, it admits that there is a rationale for the bad faith disallowance. (RRB at 59.) However, the parties dispute how this section should be interpreted and applied for purposes of 20th Century's rollback obligation.

The evidence showed that 20th Century had one bad faith trial judgment against it in 1989 in *Algee v. 20th Century,* in which the jury awarded $50,000 in compensatory damages. The jury also awarded $1 million in punitive damages, but the trial judge granted the company's motion for a new trial on that issue. The appellate court subsequently affirmed, and petitions to the California Supreme Court were denied. Sometime after 1989, 20th Century paid the plaintiffs the $50,000 compensatory damages, plus costs and interest. 20th Century also incurred ALAE (legal defense costs) in 1989, bringing the total of compensatory damage and 1989 ALAE in *Algee* to $172,681. (Corrected Second Joint Motion of the Department and Respondents for the Introduction of Exhibits at 2; ALJ-20 [Exh. 4-A-2 thereto].) The punitive damages issues remains to be retried in superior court. (Res-31A; RT 2 am at 83-84.) Prior to 1989, 20th Century paid $11,629.50 in ALAE, and after 1989 to date it has paid an additional $61,661.95 in ALAE. (Petit Declaration dated March 9, 1992 and admitted in evidence March 17, 1992.)

The only other litigation that resulted in a bad faith judgment at the trial court level in which 20th Century incurred legal expenses (ALAE) in 1989 was *James v. 20th Century.* The verdict for $397,800 in compensatory damages, contractual benefits and attorneys fees

was rendered in 1990 (Res-31B; RT am at 83-85.) Legal expenses (ALAE) paid in 1989 in *James* were $53,516.72. That case is pending on appeal. (*Idem.*)

Consistent with industry practice, 20th Century does not reserve for bad faith liability in advance of trial court judgments or settlements. Thus, in contrast to other types of liability for which insurers do reserve, "incurred" losses are artificially limited to "paid" losses in the context of bad faith judgment expenses. (RT 12 am at 67; RT 10 pm at 150-52; RT 2 pm at 132.) Therefore, although the regulations generally determine the Constitutional percentage on an earned/incurred basis with incurred including reserves, this is not possible with respect to bad faith expenses.

The parties dispute whether "judgment" as used in the regulations should be interpreted as a trial court judgment as the Department and Voter Revolt urge, or only as a "final judgment" in the more restrictive sense, i.e., a judgment that is safe from review in that no timely appeal was taken or all appeals have been exhausted, as Respondent advocates.[15] (DOB at 17-18; DRB at 35-36; ROB at 47-48.) In addition, the parties dispute the extent to which ALAE associated with bad faith judgments in 1989 but incurred in the years before or after 1989 should be disallowed. The Department and Voter Revolt now contend that all ALAE before and after 1989 associated with a bad faith judgment in 1989 (in 20th Century's case only *Algee*) should be disallowed. 20th Century argues that only bad faith judgments in 1989 from which all appeals have been exhausted should be disallowed—of which it had none.

Hunter testified for the Department that trial court judgments in the rollback year should be disallowed in

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[15] Respondent acknowledges that a trial court judgment is also considered a "final judgment" (as distinct from an interlocutory judgment) for purposes of appeal, but urge us to adopt the other definition. (ROB at 47.)

rollback proceedings even if they were subsequently appealed, stating that a subsequent reversal or settlement for a lower amount could be accounted for in later rate hearings by crediting the difference to allowable losses when the reversal or settlement occurred. (RT 3 am at 38-39; RT 12 at 70-71.) He further testified that since 20th Cenutry, like other insurers, did not reserve for bad faith, and since until there is an adverse judgment it is not known whether defense costs incurred prior to judgment are subject to disallowance, 1989 ALAE alone should not be used. He recommended that the rollback disallowance be calculated based solely on any adverse bad faith judgments in trial court in 1989, but that ALAE in association with such 1989 judgments that was incurred in 1989 or earlier be recognized in that year. (RT 12 am at 67-69.) He recommended that settlements prior to judgment should not be taken into account in rollback calculations because those settlements would be too difficult for insurers and the Department to monitor, although he noted that prospectively a reporting system could be set up to track prejudgment settlements. (*Idem.*)

As noted above, the only bad faith judgment against 20th Century in 1989 was *Algee,* which was at the trial court level. Thus, Hunter did not propose disallowance of the ALAE incurred in 1989 associated with *James* since the adverse judgment in that case occurred in 1990. Hunter recommended disallowance of ALAE associated with *Algee* incurred prior to and during 1989, but his testimony did not expressly address treatment of ALAE incurred with respect to *Algee* after 1989. (RT 3 am at 38; RT 12 am at 68].) However, the Department now advocates disallowance of the judgment and all ALAE associated with *Algee* whether incurred before, during or after 1989, a total of $245,972. (Amended Joint Motion of the Department and Respondents for the In-

troduction of Exhibits into Evidence, filed on March 13, 1992, at 3.)

20th Century counters that use of its restrictive definition of judgment in the sense of all appeals in the entire case being exhausted is the more efficient and accurate approach, because it only requires analyzing expenditures associated with a bad faith judgment once in a single ratemaking proceeding, at a time when the insurer's liability is finally determined and no longer subject to reversal. 20th Century argues that by contrast Hunter's proposal for credits in later ratemaking proceedings if a judgment is subsequently reversed is inefficient because it may require adjustment of disallowances associated with the same case in more than one ratemaking proceeding. 20th Century correclty points out, and the Department concedes, that use of "final" judgment in the sense, that it advocates, i.e., all appeals in a case have been exhausted, is a neutral rule not biased in favor of insurers over consumers. Since there is no reason to except that in the rollback year there were fewer "final" bad faith judgments than trial court bad faith judgments on an industrywide basis, there is no reason to believe that using 20th Century's definition of "final" judgment will result in any lower aggregate disallowance than use of the Department's definition of trial judgment. (RT 15 at 96-97.) However, under the approach urged by 20th Century, it would have no bad faith disallowance in the rollback year since the punitive damages portion of *Algee* is being retried, even though the compensatory damages award was affirmed on appeal and has indeed been paid.

20th Century also argues, with some merit, that as it stands the Department's proposal for treating subsequent reversals of judgments previously disallowed is imperfect. On cross-examination, Hunter conceded that if the company did not seek a rate increase in the year a bad faith judgment whose costs had previously been excluded was reversed, it would not recover those disallowances. (RT

23 pm at 116-18.)[16] 20th Century further contends that under the regulations' use of three years' data to compute projected losses in future rate proceedings (§§ 2644 and 2642.6), credit in the year of reversal will not necessarily result in full recovery because of trending. (ROB at 46 & n.2.) At oral argument, the Department disputed 20th Century's assumption that loss trending under the regulations applies to expenses excluded under § 2644.10, and stated that the regulations are silent on the treatment of bad faith judgments in prospective ratemaking and a satisfactory method could be devised. (RT 15 at 94, 103-04.) While that is very likely correct (see, e.g., RT 15 at 96), as of yet the Department has not specifically identified the method by which an insurer would be made whole for a previous disallowance related to an overturned trial court judgment.

On the other hand, 20th Century's definition of judgment as one from which all appeals have been exhausted would delay the disallowance of awards on causes of actions or claims from which there is no further appeal just because other claims in the same action are still being litigated. *Algee* illustrates this point, since the appellate court already upheld the award of compensatory damages and only the punitive damages award is set for retrial. Thus, while the restrictive definition of judgment proposed by 20th Century does simplify accounting for costs associated with a particular case by addressing them only once, in a single ratemaking proceeding, it delays the disallowance of bad faith expenses—perhaps for several years—even after they have been finally determined and are no longer subject to any uncertainty.

20th Century also objects that even if "judgments" under the regulations are interpreted as trial court judg-

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[16] The Department pointed out in oral argument that by the same token if an insurer does not seek a rate increase in a year it suffers a large adverse bad faith judgment, there is no disallowance. (RT 15 at 94-95.)

ments, disallowance in the rollback calculation of associated ALAE incurred before and after 1989 is not proper. It cites the provision of the regulations stating that "[H]istoric data shall be used in lieu of forecasts for the rollback period." (§ 2645.2(d).) That provision by itself does not necessarily preclude use of historic data in other years to determine the rollback, particularly since in context the term historic data is meant as actual recorded data in contradistinction to forecasts of expected results. Moreover, historic data normally includes loss reserves as well as paid losses; since bad faith liability is the exception to this rule, simply using amounts paid in 1989 in association with bad faith judgments arguably understates the proper disallowance.

Nonetheless, to disallow non-rollback year costs for rollback purposes as proposed by the Department would result in calculation of the rolled-back rates based on expenses incurred and reported in the company's books in other years, including years prior to the effective date of Proposition 103's rollback provision. This may be justified as the Department urges as a proxy for the practical unavailability of complete data on expenses related to bad faith conduct in the rollback year, especially in light of the industry's unique treatment of bad faith liability and the Department's willingness to forgo rollback disallowances for pre-judgment settlements. However, it is an imperfect proxy and disallowance of pre-rollback year expenses arguably affects rates prior to November 1988. Further, disallowing post-1989 expenditures in the rollback calculation was not expressly recommended by the Department's expert, and an alternative, potentially more accurate method is available—to make disallowances in subsequent ratemaking proceedings for expenditures incurred after 1989 but associated with bad faith judgments in 1989. (At the same time, the disallowance of ALAE in 1989 now known to be associated with bad faith judgments after 1989 would be proper under the approach

adopted here, although we make no such disallowance in 20th Century's case.)

The Department correctly notes that the dispute over how to measure the bad faith judgment disallowance is not an issue of major dollar significance to 20th Century's rollback (RRB at 36), as indeed it is unlikely to be for most insurers. However, determining the best method requires us to balance competing public policy goals and competing interests of consumers and insurers. On the one hand, as Respondent acknowledges, there are strong public policy reasons against consumers shouldering insurers' burden of paying legitimate bad faith claims and the legal expenses incurred to fight them, and disallowance of such expenses should not be unnecessarily delayed. On the other hand, the method for computing the disallowance should not penalize insurers who incur legitimate expenses in the successful defense of unmeritorious claims, and also should not be unduly cumbersome to administer. Further, in the absence of a bad faith tracking system or reserves for the rollback year, the method should provide a workable substitute while if possible avoiding the use of expenses not carried on insurers' books in the rollback year.[17]

20th Century's and the Department's proposals for treating bad faith judgments each have advantages and disadvantages when measured against these competing goals, and neither merits adoption in total. In the absence of a concrete proposal of a method which will accurately adjust in future ratemaking proceedings for reversals of bad faith trial judgments on appeal, we will construe bad faith "judgment" as a judgment from which all appeals have been exhausted *as to that particular bad faith claim or award.*[18] However, we reject Respondent's proposal

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[17] As Hunter testified, such a tracking system could be devised for future ratemaking.

[18] As we use this term here, a claim for compensatory damages for bad faith is distinct from a claim for punitive damages for

that all proceedings must be exhausted on the entire case, even when an award of damages for bad faith has been finally determined (as it has here on the compensatory damages claim). Therefore, the compensatory damage award in *Algee* in 1989, which has been affirmed on appeal, should be disallowed in the rollback calculation, even though the punitive damages claim is still being litigated. Since the trial court judgment in *James* is pending on appeal and no portion of it has been affirmed, and since none of the parties advocate any disallowance in that case, no disallowance will be made in connection with *James*.[19]

Regarding the disallowance of ALAE associated with *Algee*, although it is a close question, we conclude that disallowance of ALAE should be limited to that incurred in the rollback year for the reasons set forth above. We note, however, that it may be appropriate to adopt a different basis for calculating the disallowance of bad-faith associated ALAE in prospective ratemaking.

Therefore, excluded bad faith expenses for 20th Century in this proceeding consist of compensatory damages plus ALAE incurred in 1989 in *Algee*, a total of $172,681.

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bad faith, regardless of whether the two are actually pled as separate causes of action (as they often are) or instead as one cause of action for bad faith but with prayers for the two different types of relief.

[19] However, we note that under the approach to ALAE associated with bad faith judgments that we adopt here, were it not for the fact that all the damages awarded in *James* are pending on appeal and thus potentially reversable, even though the judgment was rendered in 1990 we believe it would be appropriate to disallow ALAE associated with *James* incurred in 1989, bringing the total disallowance to $226,198. (See Corrected Joint Motion, filed April 7, 1992, at 2.) Disallowing all ALAE incurred in 1989 now known to be associated with a bad faith judgment, whether rendered before or after 1989, is consistent with the regulations and the statute and properly balances fairness to consumers and insurers.

II. RESPONDENT'S STATUTORY AND CONSTITUTIONAL CHALLENGES

A. *The Commissioner's Authority to Consider Respondent's Challenge to Its Rollback Determination as Unconstitutional "as Applied" and Contrary to Proposition 103*

At the threshold we address the issue of our authority to consider Respondent's challenge to the rollback regulations as unconstitutional "as applied." As explained more fully below, *Calfarm* contemplated that the Insurance Commissioner would make an administrative determination whether a 20 percent rollback rate is "inadequate" as applied to a particular insurer in the sense that it is unconstitutionally confiscatory, and if so what higher rate is constitutionally required. (48 Cal.3d at 822 & n.15, 825; *see* Section III.B., below.) Therefore, the statutory and constitutional issues intersect the Commissioner's administrative determinations. Respondent submitted extensive evidence designed to prove that the regulations are invalid as applied to it based on statutory, constitutional and policy grounds, including three experts and several company officials who filed more than 250 pages of written testimony (including exhibits) and also testified orally for some nine days. Further, the parties, including intervenors Voter Revolt and Allstate, briefed the statutory and constitutional issues. The parties agree that the Administrative Law Judge and the Commissioner should consider and decide in the first instance whether the regulations governing rollbacks as applied to 20th Century meet constitutional standards. (DOB at 18-19; ROB at 53.)

In light of *Calfarm*, we believe that it is appropriate to consider the constitutional challenges raised by 20th Century. Article 3, Section 3.5 of the California Constitution, which forbids an administrative agency from declaring a statute unconstitutional or refusing to enforce it as unconstitutional unless an appellate court has so

determined, is not to the contrary.[20] It does not affect our authority to interpret existing law in the course of discharging our duties and to consider evidence offered before us in light of constitutional standards. (*See Goldin v. Public Utilities Commission* (1979) 23 Cal.3d 638, 669 & n.18, 153 Cal.Rptr. 802, 822 & n.18; *Lewis-Westco v. Alcoholic Bev. Cont. App. Bd.* (1982) 136 Cal.App.3d 829, 840 n.12, 186 Cal.Rptr. 552, 560 n.12; *Regents of U. of Cal. v. Public Employment Relations Board* (1983) 139 Cal.App.3d 1037, 1042, 189 Cal. Rptr. 298, 301-02; *Dash, Inc. v. ABC App. Bd.* (1982) 683 F.2d 1229, 1234; *Board of Police Comm'rs v. Superior Court* (1985) 168 Cal.App.3d 420, 431, 214 Cal.Rptr. 493, 498-99; *Woods v. Superior Court* (1981) 28 Cal.3d 668, 677, 680-81, 170 Cal.Rptr. 484.)

B. *The Standard for Determining Rollback Rates Under Proposition 103 as Modified by Calfarm*

1. *Calfarm's Modification of Proposition 103 to Ensure That the Rollback Rates Are Not Unconstitutionally Confiscatory*

The parties dispute the statutory and constitutional standard that governs these hearings under Proposition

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[20] Article 3, § 3.5 of the California Constitution provides:

"An administrative agency, including an administrative agency created by the Constitution or an initiative statute, has no power:

(a) To declare a statute unenforceable, or refuse to enforce a statute, on the basis of it being unconstitutional unless an appellate court has made a determination that such statute is unconstitutional;

(b) To declare a statute unconstitutional;

(c) To declare a statute unenforceable, or to refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations."

103 as modified by *Calfarm,* 48 Cal.3d 805, 258 Cal. Rptr. 161, in light of constitutional requirements. 20th Century and intervenor Allstate urge us to disregard Proposition 103's rollback provision entirely and simply assess whether Respondent's rates were excessive or inadequate in themselves under section 1861.05 read in isolation, untethered from section 1861.01(a)'s provision for an intial 20 percent reduction in rates. Since 20th Century charged among the lowest rates in the industry, it argues that it is immune from any rollback. Under its analysis, rate of return (in 20th Centry's case among the highest in the industry) is irrelevant.

The Department and Voter Revolt respond that this position is contrary to law, and is a belated attempt to relitigate Proposition 103 as interpreted by *Calfarm* and the regulations that the Commissioner has adopted to implement it. They are correct. Respondent's and Allstate's argument ignores the fact that Proposition 103's provision for a uniform reduction of insurance rates by 20 percent, regardless of whether the rates were low or high by industry standards, remains the starting point for determining rollback year rates. This requirement is subject only to a showing by a particular insurer that the full 20 percent reduction would deprive it of the minimum nonconfiscatory rate of return. Moreover, the policy choice to reduce rates throughout the industry, for both higher and lower priced insurers, has already been made by the voters.

An examination of *Calfarm* demonstrates the error of Respondent's position. Proposition 103 imposed an across-the-board 20 percent rollback of property-casualty insurance rates under Insurance Code section 1861.01 (a). The only exception permitted was an insurer's showing that it was substantially threatened with insolvency under section 1861.01(b). In *Calfarm,* the California Supreme Court considered a facial challenge to the constitutionality of the rollback. It refused the insurers' plea to strike down section 1861.01(a), which imposed the

20 percent reduction, and instead left that provision in place. However, the Court was concerned that there be an adequate mechanism for an insurer to obtain relief from the initial 20 percent reduction in rates if the full 20 percent rollback precluded it from earning a fair rate of return, pursuant to the constitutional standard established by *Hope,* 320 U.S. 591, 64 S.Ct. 281, and its progeny. (48 Cal.3d at 816-18 & n.9; see Section II.B.2, below.) It found that section 1861.01(b) did not provide an adequate safeguard against the potentially confiscatory impact of a full 20 percent reduction on a particular insurer, since an insurer might be deprived of a fair rate of return yet not be "substantially threatened with insolvency." (*Calfarm,* 48 Cal.3d at 818-20 and n.9.)

However, the Court held that section 1861.01(b) was severable from the rest of Proposition 103's rate rollback scheme because the Commissioner retained authority to grant relief from confiscatory rates under section 1861.05 ((b), which *inter alia* bars "inadequate" rates. The Court reasoned that "a confiscatory rate is necessarily an 'inadequate' rate. . . ." (48 Cal.3d at 817, 822-23 and n.15.) The logical corollary of the Court's interpretation of Proposition 103 is that "excessive" under section 1861.05 as applied to the rollback year means rates above the minimum nonconfiscatory rate. While Allstate now argues that this interpretation departs from that provision's traditional interpretation, the Court expressly noted that its construction of "inadequate" as synonymous with "confiscatory" was supported both by the rule that statutes should be construed to preserve their constitutionality and by its plain language. (*Id.* at 822 n.15.)[21]

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[21] 20th Century and Allstate each cite *Guaranty Nat. Ins. Co. v. Gates* (9th Cir. 1990) 916 F.2d 508. The federal appellate court there considered a Nevada statute similar in some respects to Proposition 103. Like *Calfarm,* the Ninth Circuit invalidated as too narrow the substantial threat to insolvency standard for relief

Based on its interpretation of section 1861.05(a) as modifying the flat 20 percent reduction in rates in section 1861.01(a) where necessary to prevent the deprivation of a fair rate of return, the Court approved the Commissioner rolling back rates by 20 percent or a lower percent if necessary to guarantee a minimum constitutional rate:

> *"If the commissioner finds the initiative's rate, or some other rate less than the insurer charged, is fair and reasonable, the insurer must refund excess premiums collected with interest.* No insurer, however, will be compelled to charge the rates set by the initiative unless it either acquiesces in that rate or is *unable to prove that a higher rate is constitutionally required."* (*Id.* at 825 [emphasis added].)

The Court noted in a footnote to that passage that the administrative record of the individual insurer hearing would aid judicial review of any claim of confiscation. (*Id.* at 825 n.18.)

2. *The Constitutional Rate of Return Standard For Determining a Nonconfiscatory Rollback*

As explained above, *Calfarm* adopted the standard established by *Hope* and its progeny for assessing the constitutionality of the rollback rates: whether the rates as finally set result in a fair rate of return or one that is confiscatory. (*Calfarm*, 48 Cal.3d at 816.) As *Calfarm* explained, quoting *Hope*, " '[I]t is the result reached not

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from the rollback. However, at that point, the appellate court found a

> *"critical divergence between the Nevada and California legislation.* Proposition 103 nowhere defines the term 'inadequate,' whereas the Nevada Insurance Code does . . . [such that it] guarantees only that an insurer will break even; it does not guarantee the constitutionally required 'fair and reasonable return.' " (*Id.* at 515 [emphasis added].)

Based on this distinction, the court held that the Nevada insolvency provision was not severable, unlike California's.

the method employed which is controlling.' " 48 Cal.3d at 816. (*Accord Fisher v. City of Berkeley* (1984) 37 Cal.3d 644, 683, 209 Cal.Rptr. 682.) In striking down the "threatened with insolvency" provision as too stringent to insure a fair rate of return, *Calfarm* noted *Hope*'s explanation that a fair rate of return must include revenue for capital as well as operating costs, and " 'the return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.' " (48 Cal.3d at 818 n.9 [quoting *Hope,* 320 U.S. at 603].)

While Respondent stresses only the investor branch of the *Hope* standard, *Hope* also taught that the determination of just and reasonable rates "involves a balancing of the investor and the consumer interests.' While rates cannot be so low as to destroy the regulated business,

> "[R]egulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness." (*Permian, supra,* 390 U.S. at 769, 88 S.Ct. at 1361 ([citation omitted].)

Permian explained that the *Hope* criteria must be adapted to fit the particular type of regulation and are not exhaustive:

> [the *Hope*] criteria, suitably modified to reflect the special circumstances of the area regulation, remain pertinent, but they scarcely exhaust the relevant considerations. (*Permian,* 390 U.S. at 791.)

Subsequent cases have elaborated on the *Hope* standard. *Duquesne Light Co. v. Barasch* (1989) 488 U.S. 299, 109 S.Ct. 609 (cited with approval in *Calfarm,* 48 Cal.3d at 816), summarized the case law on the standard for judging whether or not rate regulation is so stringent as

to amount to a taking in violation of the Fifth and Fourteenth Amendments:

> "The guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory. *Covington & Lexington Turnpike Road Co. v. Sandford,* 164 US 578, 597, 17 S.Ct. 198, 205-06, 41 L.Ed. 560 (1986) (A rate is too low if it is 'so unjust as to destroy the value of [the] property for all the purposes for which it was acquired,' and in so doing 'practically deprive[s] the owner of property without due process of law')"; *FPC v. Natural Gas Pipelines Co.,* 315 U.S. 575, 585, 62 S.Ct. 736, 742, 86 L.Ed. 1037 (1942) ("By long standing usage in the field of rate regulation, the 'lowest reasonable rate' is one which is not confiscatory in the Constitutional sense"); *FPC v. Texaco Inc.,* 417 U.S. 380, 391-92, 94 S.Ct. 2315, 2323, 41 L.Ed.2d 141 (1974) ("All that is protected against, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level.") (*Duquesne, supra,* 488 U.S. at 307-08, 109 S.Ct. at 615-16.)

The Constitution does not dictate a particular method of setting rates:

> "We are not obliged to examine each detail of the Commission's decision; if the 'total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry . . . is at an end.' " (*Permian Basin Area Rate Cases* (1968) 390 U.S. 747, 767, 88 S.Ct. 1344, 1360 [*"Permian"*] [quoting *Hope*].).

Similarly, there is a wide "zone of reasonableness" within which a regulatory agency can exercise its discretion to set rates that balance the interests of investors and consumers. (*Permian, supra,* 390 U.S. at 767, 88 S.Ct. at 1360; *see Calfarm, supra,* 48 Cal.3d at 822-23 ["section

1861.05 requires rates within that range which can be described as fair and reasonable"]; *Texaco Puerto Rico, Inc. v. Rodriguez* (D.P.R. 1990) 749 F.Supp. 348, 358 ["The leeway afforded by a wide zone of discretion is needed so that an agency may properly balance the interests of investors against its mandate to protect consumers."].)

In short, the Constitution does not operate as a straightjacket on agencies who face the complex task of balancing competing interests in regulating rates:

> "The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties." 109 S.Ct. at 619.

The Lochnerian era in the early twentieth century when the judiciary closely scrutinized economic regulations and often found them unconstitutional has long since passed. (*See Texaco Puerto Rico, supra,* 749 F.Supp. at 368; *Williamson v. Lee Optical* (1955) 345 U.S. 483, 488-89 ["The day is gone when this Court uses the Due Process Clause . . . to strike down state laws, regulatory of business and industrial conditions, because they may be unwise, improvident, or out of harmony with a particular school of thought"].)

Accordingly, those who argue that a regulated rate is confiscatory must "overcome a presumption of validity" which attaches to the agency's expertise, and must bear:

> " 'the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.' " (*Permian, supra,* 390 U.S. at 767, 88 S.Ct. at 1360 [quoting *Hope*].)

The teachings of *Permian* are particularly significant to the resolution of the constitutional challenge in this case. While Respondent attempts to distinguish *Permian* as

involving "price cap" rather than a rate-of-return regulation, that distinction is largely illusory because the *Permian* prices were based on a uniform rate of return. (*Id.* at 761-62.)

Permian approved the Federal Power Commission's setting of area-wide prices for natural gas producers based on average cost data, despite the fact that individual producers' costs varied, based *inter alia* on their luck in discovering gas. Noting that the Commission adopted this method to avoid regulatory paralysis, the Court stressed that:

> "We must reiterate the breadth and complexity of the Commission's responsibilities demand that it be given every reasonable opportunity to formulate methods of regulation appropriate for the solution of its intensely practical difficulties." (390 U.S. at 790, 88 S.Ct. at 1372.)

C. *Applying the Standard of Confiscation to 20th Century*

1. *Respondent's General Attack on the Regulations for Not Allowing it an Individualized Rate of Return*

20th Century argues that the 10 percent rate of return established by the Commissioner's regulations is insufficiently tailored to its own higher cost of capital and thus is unconstitutionally confiscatory when applied to it. However, Respondent's argument is legally and factually unpersuasive and it has failed to meet its heavy burden of convincingly demonstrating that the rollback is "invalid because it is unjust and unreasonable in its consequences." (*Permian*, 390 U.S. at 767.)

As our previous discussion in Section III.B shows, regulations may reduce the rate of return to investors below what the unregulated market provides and may do

so through broad determinations based on average data, with only limited provisions for exceptions in situations of true financial hardship. Thus, the courts have repeatedly held that agencies

> "may calculate rates for a regulated class without first evaluating the separate financial position of each member of the class; it has been thought to be sufficient if the agency has before it representative evidence, ample in quantity to measure with appropriate precision the financial and other requirements of the pertinent parties." (*Permian,* 390 U.S. at 769; *see also id.* at 803 n.79.)

Further, as long as the rate of return chosen by the Commissioner does not jeopardize the continuing operations of the insurer, the fact that it may burden some insurers more than others does not entitle the more adversely affected insurers to relief. (*See, e.g., Bowles v. Willingham, supra,* 321 U.S. at 517 ["[o]f course, price control, the same as other forms of regulation, may reduce the value of the property regulated"]; *Baltimore & Ohio RR Co. v. United States, supra,* 345 U.S. at 148 ["So long as a railroad is not caused by such regulations to lose money on its over-all business, it is hard to think that it could successfully charge that its property was being taken for public use 'without just compensation' "]; *Permian Basin,* 390 U.S. at 770-71 [inability to recover unsuccessful exploration costs or full rate of return on investment would not justify exemption from maximum rate; only grounds for relief would be a demonstration that out-of-pocket expenses exceed revenue]; *Andrus v. Allard* (1979) 444 U.S. at 66 ["loss of future profits . . . provides a slender reed upon which to rest a takings claim"]; *Fisher v. City of Berkeley, supra,* 37 Cal.3d at 687 ["[e]ven a significant diminution in value is insufficient to establish a confiscatory taking"]; *Hutton Park Gardens, supra,* 350 A.2d at 15 ["[t]he rate of return permitted need not be as high as prevailed in the

industry prior to regulation nor as much as an investor might obtain by placing his capital elsewhere"].)

While exemptions from regulations based on industry averages cannot be limited to a showing of bankruptcy or insolvency, even the cases relied upon by Respondent establish that "absent the sort of deep financial hardship described in *Hope*, there is no taking. . . ." (*Jersey Cent. Power & Light Co. v. F.E.R.C.* (D.C.Cir. 1987) 810 F.2d 1168, 1181 n.3 [holding that utility's inability to sell senior securities, lack of creditworthiness, loss of access to long term capital, tenuousness of short term capital, no dividends on common stock for four years and zero rate of return to common equity investors established its right to a hearing on whether reduced rates ordered by Commissioner were confiscatory].) As long as the "end result" of regulation permits the regulated business to operate successfully, there is no confiscation. (*See Hope*, 320 U.S. at 606; *Market Street Railway Co., supra*, 324 U.S. at 566 ["All that was held [in *Hope*] was that a company could not complain if the return which was allowed made it possible for the company to operate successfully."].)[22]

Nowhere in the hundreds of pages of testimony, exhibits and argument that 20th Century has proffered in support of its argument of confiscation has it claimed that its rollback would pose the type of deep financial hardship or serious threat to its financial health that rises to the level of confiscation. At most, it has argued that it would not be able to expand as rapidly as it has in the past because its reduced surplus after a rollback will not support as large a growth in premiums written. (ROB at 2; Stiglitz Direct at 80.) Even assuming that this were true, 20th Century has cited no case holding that a slowdown

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[22] Regulation, of course, cannot ensure the successful operation of any given company. (*See, e.g., Federal Power Comm'n v. Natural Gas Pipeline Co., supra*, 315 U.S. at 590 ["regulation does not insure that the business shall produce net revenues"].)

in growth is confiscatory. The clear evidence that 20th Century has been able to expand rapidly largely through use of retained earnings, selling stock only once in the last six years while growing from a $500 million to a $1 billion company (RT 5 pm at 184), undercuts 20th Century's claim that it will not be able to raise new surplus if forced to roll back. Moreover, to the extent that 20th Century has already set aside reserves against its rollback liability, with a corresponding reduction in surplus, the impact of that reduction has already occurred. (RT 7 pm at 38-39.)[23] Yet 20th Century has continued to grow by more than 10 percent each year from 1989 through 1991. (Res-35A.)

In short, 20th Century's argument that the Constitution compels a variance from the 10 percent rate of return despite its failure to show "deep financial hardship" is not supported by the cases. *Permian* upheld regulations based on average industry costs despite a very limited provision for individual variance: the Commission proposed to limit exceptions to cases where operational expenses exceeded revenues, and *not* to grant variances based simply on an inability to recover unsuccessful exploration costs or the full 12 percent rate of return on production investment that the Commission used to set rates. (*Permian*, 390 U.S. at 770-71, 88 S.Ct. at 1362.)

Respondent nonetheless urges that it is constitutionally entitled to an individualized determination of its own rate of return, relying on *FERC v. Pennzoil* (1979) 439 U.S. 508, 99 S.Ct. 765 ("*Pennzoil*"). However, *Pennzoil* held that rate setting need not be tailored to individual costs of particular companies:

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[23] In addition, since the market discounts future events in advance (as Stiglitz testified in discussing the 1986 stock issuance), the market has already absorbed at least some of the effect of 20th Century's rollback. As noted, 20th Century is nonetheless still growing rapidly.

"Specifically, the Commission is not required to adhere 'rigidly to a cost-based determination of rates, much less to one that base[s] each producer's rates on his own costs.' *Mobil Oil v. FPC* (1974) 417 U.S. 283, 308, 94 S.Ct. 2328, 2346. While recognizing that under an areawide approach, 'high cost operators may be more seriously affected . . . than others,' *Permian Basin Area Rate Cases* (1968) 390 U.S. 747, 769, 88 S.Ct. 1344, 1361, . . . we refused to invalidate as inadequate the Commissioner's proposal to provide special relief when a producer's 'out of pocket expenses in connection with the operation of a particular well' exceed[s] its revenue from the well under the applicable area price.' 390 U.S. at 770-71, 88 S.Ct. at 1361-62 . . . Furthermore, *the notion that the Commissioner is required to maintain, or even allowed to maintain to the exclusion of other considerations, the profit margin of any particular producer is incompatible* not only with the specific area approach to natural gas regulation approved in *Permian Basin* and *Mobil Oil* but also *with a basic precept of rate regulation.* 'The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid.' *FPC v. Hope Natural Gas Co.,* (1944) 320 U.S. 591, 601, 64 S.Ct. 281. The Commissioner is not required by the Act to grant special relief from area or nationwide rates simply because the costs of an individual producer increase and his profits decline. . . ." (439 U.S. at 517-18 [emphasis added].)

Contrary to Respondent's suggestion, *Pennzoil* held only that FERC had the *discretionary* authority to consider variances due to increased costs; it did *not* hold that FERC was constitutionally required to grant such var-

iances. Rather, it reaffirmed that rate regulation may reduce profits.[24]

Nor is *Mobil Oil v. FPC* (1974) 417 U.S. 283, 308, 94 S.Ct. 2328, on which Respondent relies to the contrary. In *Pennzoil,* the Court specifically stated:

> "We think that the Court of Appeals read too much into our statement in *Mobil Oil* that a producer with rising royalty costs "is entitled to seek individualized relief." [Citations omitted.] We did not there suggest that the Commission must be prepared to grant such relief in order to forestall declining profits. Indeed, we rejected the claim that the Commission must 'provide automatic adjustments in area rates to compensate for anticipated higher royalty costs.' "

439 U.S. at 518-519.

Another defect in 20th Century's case for a higher rate of return is that it fails to come to grips with the

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[24] *Pennzoil* suggested that permitting adversely affected companies to exit the market was an alternative to individual rate relief from area rates. (439 U.S. at 521.) Insurers may withdraw from the California marketplace upon meeting statutory requirements for withdrawal (*see, e.g., Calfarm,* 48 Cal.3d at 831), which is another factor weighing against Respondent's arguments for expanding individual variances. In addition, unlike public utilities which have some degree of monopoly, there are multiple companies providing insurance in the California marketplace so the potential exit of any of them is of less pressing concern. As the Court explained in *Texaco Puerto Rico,* contrasting rate setting for utilities with that for private industries with multiple participants,

> "In the case of a market with private actors the focus is less on the individual company, and more on the overall industry effect. It is well accepted that price or rate setting will severely limit the profitability of some of the market participants. The court facing, for example, rent regulation, does not concern itself with the fate of each individual landlord's rate of return, but looks instead to the effect of the entire industry." (*Texaco Puerto Rico,* 749 F.Supp. at 359.)

applicable standard for determining the rollback: the minimum nonconfiscatory rate of return. Instead, Respondent has directed its evidence to the optimal prospective rate of return based on hypothetical investor expectations. In order to implement Proposition 103 as modified by *Calfarm*, the Commissioner must select a rate at or near the bottom of the range of rates which are constitutional. Yet Respondent has ignored the lower end of the range, instead focusing exclusively on the highest rate of return that might conceivably be expected by investors in 1989.

20th Century also objects to the Commission's decision to base the generic determination of the rate of return on the average historical rates of return actually achieved by the industry from 1980 through 1989, rather than theoretical investor expectations determined by econometric models. This objection is an attempt to relitigate an issue resolved by a generic determination in the RCD-2 Decision, and as such is not relevant in this proceeding. (Regulations, § 2646.4(e).)

As explained in the RCD-2 decision, the Commissioner found that the insurers' evidence based on theoretical models was not persuasive in that it did not give appropriate consideration to actual historical data and indeed conflicted with it, and resulted in an estimated cost of capital that was not the lower boundary of the range of reasonable rates of return. (RCD-2 decision at 10, para. 7.) The Commissioner's choice of historical data rather than the "back to the future" approach advocated by 20th Century is similar to the method approved in *Permian Basin*:

> "Finally, the Commission sought to determine the rate of return recently earned by producers of natural gas. It found that accurate rates of return could not be calculated with assurance, although the Commission's staff offered evidence of an average return for nine companies over five years 12.4 percent on

> net investment. The Commission concluded that, despite its statistical deficiencies, this and similar evidence must be given 'heavy consideration in the decisional process.' " (390 U.S. at 807-08.)

Use of actual historical rates of return rather than inherently speculative hypothetical projections of investor expectations is a reasonable choice, particularly for a time period now already past. (*Cf. Hope, supra,* 320 U.S. at 605 ["The incongruity between the actual operations and and the return computed on the basis of reproduction cost suggests that the Commission was wholly justified in rejecting the latter as the measure of the rate base."].)

While 20th Century may disagree with the result, the Commissioner has reasonably balanced the various interests that must be considered in setting the rate of return, giving primary consideration to the legislative objectives and the needs of the public. As the Supreme Court summarized in *Permian Basin*:

> "The Commission cannot confine its inquiries either to the computation of costs of service or to conjectures about the prospective responses of the capital market; it is instead obliged at each step of its regulatory process to assess the requirements of the broad public interests entrusted to its protection by Congress. Accordingly, the 'end result' of the Commission's orders must be measured as much by the success with which they protect those interests as by the effectiveness with which they 'maintain . . . credit and . . . attract capital.' " (390 U.S. at 791.)

2. *Respondent's Evidence In Support of Its Claim for a Deviation From the Regulation's Industry-Wide Rate of Return*

20th Century's evidence in support of a departure from the generic determination that 10 percent is the minimum nonconfiscatory rate of return falls into two categories:

(1) a general policy attack, clothed in statutory and constitutional garb, on rate of return regulation as inferior to Respondent's preferred policy of price caps, presented primarily through the testimony of Professor Priest, with some support from Professor Stiglitz and Mr. Crichfield and (2) econometric models of hypothetical investor expectations that yield the kind of high rate of return of which investors dream (but do not necessarily expect), presented by Professor Stiglitz and based in part on data analyses made under the supervision of Mr. Crichfield that Respondent claims show that it is constitutionally entitled to a rate of return in excess of 10 percent.

a. *Respondent's Price Cap and Confiscation Per Se Theories*

Respondent presented testimony by three experts, Professor Priest, Professor Stiglitz and Mr. Crichfield, in support of its statutory and constitutional challenges to 20th Century's rollback to the effect that: (a) rate of return regulation should be confined to natural monopoly industries, and in competitive industries no regulation is best but at most price cap regulation should be imposed; (b) California's insurance industry is competitive; (c) 20th Century is immune from any rollback because its prices would be below any price-cap and its high rate of return should not be regulated. (See ROB at 73-75; DOB at 21-22.) This price cap theory is really a policy argument. However, Respondent attempts to elevate it to a statutory mandate, based on Proposition 103's goal of improving competition in the insurance market, and even a constitutional mandate, based on a novel theory of confiscation. (ROB at 86-97.)

Respondent's statutory argument contends that the rollback is inconsistent with Proposition 103's pro-competition policy. Respondent is correct that Proposition 103 sought to foster competition by repeal of the state antitrust exemption and dissemination of comparative price information. However, Respondent would have us completely

ignore Proposition 103's express policy of reducing *all* insurance rates, including those at the lower end of a market that the voters evidently felt was fundamentally flawed from top to bottom. While Respondent may believe that the goal of rolling back prices for all insurers is inconsistent with the goal of improving competition, the voters evidently did not. Regardless of whether the academic pendulum has swung towards favoring "price cap" rather than rate of return regulation, as Professor Priest opined, a price cap regulation that would leave untouched the rates of 20th Century and other insurers at the low end of the market is inconsistent with the governing statute. *Calfarm* modified the statutory rollback only to the extent necessary to ensure a constitutional rate of return —something that 20th Century's price cap theory might well fail to achieve for companies with legitimately high expenses (e.g., because they insure high risk drivers). Thus, the regulations are faithful to the statute as modified by *Calfarm* where 20th Century's preferred policy alternative is not.

Respondent's desire to rewrite Proposition 103 based on policy testimony cannot substitute for statutory and constitutional analysis. As the California Supreme Court recognized:

> "[O]ur duty is clear: 'We do not consider or weigh the economic or social wisdom or general propriety of the initiative. Rather, our sole function is to evaluate [it] legally in the light of established constitutional standards.' " (*Calfarm,* 48 Cal.3d at 814 [citations omitted].)

The Supreme Court recently underscored once more the deference due to democratically enacted initiatives:

> "the initiative power must be *liberally construed* to promote the democratic process. Indeed, it is our solemn duty to jealously guard the precious initiative power, and to resolve any reasonable doubts in favor of its exercise. (*Legislature of State of California v.*

Eu (1991) 54 Cal.3d 492, 286 Cal.Rptr. 283, 287 [emphasis in original; citations omitted].)

Respondent's novel constitutional theory holds that any rollback of its rates is confiscatory *per se* because it was a successful competitor in the insurance market and hence deserves to keep the high profits that it earned, free from any "retroactive" reduction. This theory rests primarily on the testimony of Professor Priest. (ROB at 72-75.)[25] This theory, too, is legally flawed. The Constitution neither requires price caps nor forbids reducing profits of successful suppliers in competitive industries. (*See, e.g., Permian,* 390 U.S. at 756-57 [upholding area rates imposed on producers of natural gas, whom the Court stated "cannot usefully be classed as public utilities. . . . They are intensely competitive vendors. . . ."]; *Fisher v. City of Berkeley, supra,* 37 Cal.3d 644 [upholding regulation of the rental market].)

Nor is the rollback "retroactive," since Respondent knew of the enactment of Proposition 103 but elected to defer

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[25] Professor Priest's prefiled testimony was properly excludable because it consisted generally of inadmissible opinion on questions of law (*see, e.g., Downer v. Bramet* (1984) 152 Cal.App.3d 837, 842, 199 Cal.Rptr. 830; *Williams v. Cooms* (1986) 179 Cal.App.3d 626, 638, 224 Cal.Rptr. 865) and irrelevant policy views. It also was directed toward relitigating issues determined in the rulemaking proceedings (RH-291). In fact, his prefiled direct testimony was in large part virtually identical to the comments that he filed in RH-291, and in view of its general policy nature was more properly directed to the rulemaking proceeding than this adjudicatory hearing. However, it was admitted here because the Department did not object to it at the Second Prehearing Conference. Since the Department waited until after the completion of his cross-examination and almost all his redirect to raise this objection, its subsequent motion to strike was denied. (See "Opinion and Order Denying Respondents' Motion to Strike Portions of the Cross-Examination of Joseph Stiglitz and Denying Department's Motion to Strike Testimony of George Priest," filed on March 11, 1992, at 12-15.) In view of these defects, his testimony is not persuasive and is entitled to very little, if any, weight.

its rollback with full knowledge that it might be required to make refunds. (See Section III.D, below.) Notably, *Permian* upheld a similar refund procedure. There, the Commission announced that it would require refunds by further order in the future of the difference between the amounts collected during the periods subject to refund and the amounts that would later be found permissible under to-be-determined, not yet final area rates, including any downward quality adjustment. (390 U.S. at 765, 825-26, 88 S.Ct. at 1358-59, 1390-91.)

Moreover, the electorate entrusted the Insurance Commissioner to implement Proposition 103 by filling in its details within his broad discretion in the exercise of his expertise. (*See Calfarm,* 48 Cal.3d at 824.) Thus, testimony by insurance industry experts advocating a different policy approach from the electorate's and the Commissioner's (an approach which happens to be more favorable to the insurer sponsoring their testimony) is irrelvant.

In view of the irrelevance of Respondent's preferred price cap policy, Respondent's evidence regarding the level of its prices compared to those of other insurers and the degree of competition in the insurance market is irrelevant. Further, as noted above, the electorate evidently believed that even insurers at the lower end of the market charged excessive prices, and that the market was flawed throughout. Even if the price cap theory were relevant, however, evidence was produced in this proceeding which cast doubt on 20th Century's claim to being a low-cost provider due solely to its own superior efficiency. The evidence also cast doubt on its experts' claim that the market was in a robustly healthy state of competition in 1989.

Although the Department's price surveys for 1989 and 1990 show that 20th Century's prices are among the lowest for the types of customers whom 20th Century writes, the surveys do not show data for three of the examples on which the price comparisons were based. This is be-

cause the examples involved youthful drivers licensed less than three years, whom 20th Century does not insure unless they happen to be the children of customers whom it already insures. (RT 13 am at 12-13.)

The evidence established that 20th Century's low prices result in large part from two factors, as stated in its own Automobile Quotation/Application form:

> "OUR RATES ARE LOW FOR TWO IMPORTANT REASONS:
>
> "1. We employ no agents and pay no commissions. . . .
>
> "2. We're selective . . . we make it our strategy to insure only responsible drivers. . . ." (Res-82.)

The evidence also showed that 20th Century enjoyed other operational efficiencies such as handling much of its insurance defense work in-house. However, its market niche has primarily been insuring consumers who are superior risks and/or who do not require or desire to pay for the personal service of agents. While Proposition 103's "take-all-comers" provision has reduced 20th Century's selectivity since it took effect on November 8, 1989 (Ins. Code, prior § 1861.02(d)), before that time 20th Century would not sell new coverage to applicants in a number of categories, including: those under age 25 (RT 13 pm at 141-42); those with less than two years of continuous insurance coverage prior to their application to 20th Century (*id.* at 143); those in households including any enlisted military personnel (*id.* at 136-37); and the unemployed (other than retirees). (*Id.* at 153). Because of its unusually high customer-retention rates of 93 to 95 percent (RT 3 pm 157-58; RT 13 am at 8, 10), even with the all-comers requirement for new business recently in effect, 20th Century's customer base remains skewed toward such preferred risk groups.

20th Century also favors certain occupations through preferential pricing. (RT 13 am at 8-82.) It conducts no advertising directed to non-English-speaking consum-

ers, nor does it ensure that it has sufficient telephone operators capable of handling non-English speaking customer inquiries. (*Id.* at 64, 74-75.) 20th Century has commendably insured many consumers in the Los Angeles area, as reflected in its past success under the former Urban Credit Program. However, there were doubtless numerous consumers in that region who met its selective criteria.

The evidence presented by 20th Century on the competitiveness of the insurance market must be considered in light of certain anti-competitive factors in the marketplace. First, we take note that the industry has long had a special exemption from the federal antitrust laws (15 U.S.C. § 1013(b)), and prior to Proposition 103 the ratemaking activities of property-casualty insurers were exempt from state antitrust laws. (*See* Ins. Code § 1861.03.) Even after Proposition 103, the industry has unique "collaborative" institutions such as rating bureaus. (Ins. Code § 1855.2.) Moreover, comparative price shopping has doubtless been impeded by complex, non-standardized coverages and policy forms, especially prior to Proposition 103's provision for dissemination by the Department of price comparison information to aid consumers. (Ins. Code § 1861.04) The existence of a large residual market served only by CAARP (the California Automobile Assigned Risk Plan, Ins. Code § 11620 *et seq.*) casts further doubt on any rosy view of the competitive state of the market.

Respondent's flawed evidence based on market concentration calculations using the Herfindahl-Hirschman Index ("HHI") did not overcome these concerns. The utility of HHI's depends on an accurate definition of the relevant geographic market. However, Respondent did not present any convincing testimony to justify its assumption that the entire state was the relevant geographic market, given the segmentation of the market within the state. For example, 20th Century's approach treated the Southern and Northern California Auto Clubs as competitors with

each other, despite their geographic restrictions. One measure of the impact of their lack of competition is to consolidate their market share as if they were merged; this raises the HHI by more than 135 point to an index over 1000, which is the level triggering concern by the Justice Department in its review of proposed mergers. (RT 11 pm at 146-53; CDI-164 at ¶ 3.11(b).) We need not decide whether such a calculation would constitute a more accurate HHI calculation than the one sponsored by 20th Century. We simply observe that this example illustrates the importance of carefully defining the market, which Respondent failed to do. Therefore, very little weight could be placed on 20th Century's evidence of HHI calculations even if it were relevant.

b. *The Cost of Capital Evidence*

20th Century's evidence that it is entitled to double or triple the 10 percent return authorized by the regulations —or more—based on the dividend-yield and capital assets pricing models and similar constructs is *not persuasive*. It is similar to the evidence previously considered and rejected by the Commissioner, and is vulnerable for the same reasons:

> "4. Some witnesses for insurers tendered analyses employing theoretical models such as the Capital Assets Pricing Model, and concluded that investors at the beginning of the rollback period would have required the 'risk-free' rate (approximately 8%), plus a 'risk premium' of about 8% to preserve the historic relationship between insurance returns and the risk-free rate, plus a 'regulatory risk premium' of at least 2% due to passage of Proposition 103, yielding proposed rates of return in excess of 18%. Estimates by insurers' witnesses employing a Discounted Cash Flow (DCF) model yielded similar results.
>
> ". . .
>
> "6. The premise underlying virtually all the evidence presented by insurance industry parties was that rollback rates of return should be based on the

theoretical future expectations of investors back at the beginning of the rollback period, rather than on actual, historical data concerning the rates of return that property/casualty insurers have actually earned. This premise is without merit. While estimated returns are pertinent for prospective ratemaking, implementaton of the rollback does not require prospective ratemaking but rather the determination of a minimum nonconfiscatory return for a period now past. The regulations specifically acknowledge this distinction, and expressly require consideration of historical data (sections 2645.2(e) and 2643.1(e)). Actual annual historical industrywide data exist that establish the average rates of return on statutory equity for property/casualty insurers during 1989 and for many prior years. The availability of this actual data makes unnecessary the projections and estimates which underlie prospective ratemaking. Moreover, the results of the insurers' theoretical analyses are not consistent with historical data on insurance profitability both for 1989 and earlier years, which show that the industry earned an average 9.1% return on statutory equity in 1989, and over the 10 years from 1980 to 1989 averaged a 10% return on both a statutory and GAAP basis.*

"* The 1980 through 1989 annual after-tax rates of return for the property/casualty insurance industry are as follows:

"Year	Statutory accounting	GAAP accounting (estimated)
"1980	14.7%	13.1
"1981	13.3	11.8
"1982	9.3	8.8
"1983	9.1	8.3
"1984	1.7	1.8
"1985	2.8	4.0
"1986	13.9	13.6
"1987	13.2	15.4
"1988	13.2	13.6
"1989	9.1	9.6
"Average	10.0	10.0

> "7. It is hereby found that the insurers' evidence is not applicable to the regulations and is not persuasive for the purpose of establishing what value should be used for the after-tax rate of return for rollback calculations, in that the estimated cost of capital expressed by the insurers' witnesses using their various theoretical models fails to give appropriate weight or consideration to actual historical data, and indeed, conflicts with that data. Moreover, an estimated cost of capital of 16% or more, as projected by most of the insurers' witnesses, clearly does not represent the lower boundary of the range of reasonableness within the meaning of section 2645.6." (*RCD-2 Decision* at 8-10.)

20th Century has not attempted to explain why its evidence of the same type is not afflicted with the same infirmities. Its evidence is similarly directed to theoretical future expectations of investors, based on the same theoretical models and the same risk premium adders, and resulting in a similar or even higher rate of return. In short, Respondent presents the same type of evidence that the Commissioner has previously found unpersuasive and makes no effort to explain why he should credit the evidence this time.

20th Century presented the evidence in support of its claim to a rate of return above 10 percent primarily through the testimony of economist Joseph Stiglitz. His testimony suffered from inconsistencies, unsubstantiated and self-serving assumptions which drove his conclusions, and implausible extreme positions. Stiglitz's prefiled testimony purported to support rates of reutrn ranging between 35.51 and 47.41 percent. (Exhibit Stiglitz-18.)[26] Moreover, in his prefiled testimony, he suggested that these rates should be multiplied by 2.08 to adjust for the

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[26] **Exhibits attached to Stiglitz' prefiled Direct Testimony with numbered tabs were designated "Stiglitz-1" through "Stiglitz-21" at the hearing. Corrected versions were denoted with the same number plus "a", e.g., "Stiglitz-9a", etc.**

regulations' use of SAP rather than GAAP as the accounting basis (Stiglitz Direct, pp. 55-56, ¶ 125), producing rates of return ranging from 74 to 99 percent a year! However, on the witness stand Stiglitz disavowed the 2.08 multiplier that he had advocated in his prefiled testimony (RT 5 at 55-56, 58-59), most likely because by then Respondent's SAP-to-GAAP adjustment theory had already been discredited by the Department's evidence that SAP and GAAP returns for 20th Century were within one percent of each other in 1989 (CDI-102)—a fact conspicuously missing from the company's prefiled evidence. (RT 2 pm at 180-182.)

The extreme variations in the rate of return numbers that Stiglitz sponsored at different times on the issue of the rate of return required to avoid confiscation seriously undermines the credibility of his testimony. After abandoning the 2.08 multiplier, he testified variously that: 41.5 percent was "a good starting point" (RT 5 am at 57); that even with potential errors in his testimony "the lowest I could come to would be 20 percent" (*id.* at 65); and that the number was no less than 28 percent. (*Id.* at 68-69.) He finally lighted on 33 percent. (Res-64; RT 8 pm at 160-61.) Stiglitz' original testimony purported to establish the actual rate of return to which 20th Century was constitutionally entitled, and was not qualified by 20th Century's subsequent disclaimers that it was only attempting to establish an approximate rate of return to show that the Regulations' rate of 10 percent was too low. Although Respondent did not necessarily have to establish the exact rate to which it believes it is constitutionally entitled, the gyrations in the rates of return that Stiglitz advocated illustrates the unreliable nature of the methodologies on which it would have us rely, even when those methodologies are applied to a single company.

The credibility of Stiglitz' opinion is further undermined by the fact that he testified to a constitutionally required rate of return (ultimately 33 percent, earlier 41.5 percent, and even higher when he initially advocated more

than doubling his figures) that exceeds 20th Century's actual rate of return.[27] We do not believe that the Constitution mandates such generous returns to investors.

We discuss the infirmities of the methodologies upon which Stiglitz relied and his use of them in more detail below. But first we address Respondent's renewed claim that the Administrative Law Judge erred in excluding portions of the additional Crichfield testimony that it sought to introduce after Stiglitz' cross-examination. The excluded testimony went well beyond Crichfield's original prefiled testimony, and basically just seconded Stiglitz' opinion. The basis of the Administrative Law Judge's ruling was explained in detail in her "Opinion and Order Denying Respondents' Motion to Strike Portions of the Cross-Examination of Joseph Stiglitz and Denying Department's Motion to Strike Testimony of George Priest," filed on March 11, 1992, at pages 1-12. To avoid unnecessary repetition, we incorporate that opinion here by reference. Suffice it to say that the primary ground for its exclusion was that such "me, too" testimony was cumulative to and unduly repetitious of Stiglitz' lengthy testimony (including his extensive redirect), and had very limited probative value.

Respondent raises the novel argument in its posthearing briefs that as long as one party has tried but failed to make a persuasive case in support of its position on a disputed issue through one witness, corroborative testimony by another witness cannot be cumulative. (RRB at 25 & n.1.) Such a theory would make for extremely protracted hearings, with the only endpoint occurring if and when a party finally decided to concede the issue. However, exclusion of evidence on the ground that it is unduly repetitious or cumulative is a separate ground for exclusion from irrelevance (Gov't Code § 11513(c)), and

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[27] Exhibit Stiglitz-6 reports that 20th Century earned a 31.58 percent rate of return in 1989 in both auto and homeowners, and earned a rate of return ranging from 16.34 percent to 24.69 percent during the years 1985-88.

is designed to allow the judge to exercise discretion to control the proceedings and avoid the waste of time.

Respondent put forward evidence based on three theoretical models in support of its rate-of-return case: the dividend-yield model (also referred to as discounted cash flow or DCF); the risk-premium model (also referred to as the capital assets pricing model or CAPM); and an event study. We examine each in turn.

i. *The Dividend-Yield Model*

Stiglitz based his opinion in part on the dividend-yield model (RT 5 am at 66), also referred to as the discounted cash flow (DCF) model. (Stiglitz Direct, p. 45; RT 5 pm at 191.) This method seeks to calculate the present value of a future stream of dividends expected from the company. (Stiglitz Direct at 45-46.) The result consists of two components: the current dividend yield (current dividend rate divided by market price) plus an expected growth rate.

Stiglitz applied this technique to 20th Century, producing a cost of capital of 26.1 percent. (Stiglitz Direct at 45-46; Stiglitz-16.) This cost of capital results from the two components: a current dividend yield of 1.95 percent and an expected annual growth rate of the dividends of 24.1 percent. (Stiglitz-16 at 1.) While the current dividend yield is a measurable, objective fact, the expected growth rate is only a projection—a projection into the infinite future of a growth rate sustained in perpetuity. (RT 5 pm at 192-93.)

The expected growth rate projection was critical to the analysis, since the witness acknowledged that over 90 percent of the 26.1 percent purported cost of capital is attributable to the expected growth rate projection. (RT 5 pm at 192.) Yet it was shown on cross-examination to be based on an untenable assumption that the average growth rate of the period 1986 through 1991 would continue indefinitely in the future—despite the fact that 20th Century experienced extraordinary growth during this

period from a small firm into one with a significant share of the California insurance market. (Stiglitz-16 at 2; RT 5 pm at 192.) Common sense teaches that it is unreasonable to extrapolate a perpetual growth rate from that unusual period.

ii. *The Risk-Premium Model*

a. *Stiglitz' justification of a rate of return of at least 20 percent based on the rate of return for utilities adjusted by 20th Century's beta*

Stiglitz also presented a risk-premium analysis based on beta analysis, also known as the capital assets pricing model (CAPM). He first took rates of return authorized for public utilities by the Public Utilities Commission, which he put at 13 percent. (Stiglitz Direct at 39; Stiglitz-11.) He then argued that risk in the insurance industry is higher than for most regulated utilities (*id.* at 39), so an insurer's cost-of-capital must be higher than a utility's. To adjust for this presumed higher cost-of-capital, he employed "beta analysis." Beta is a measure of the volatility of a given security, which is equated with risk, compared to the volatility of the whole market; a beta of 1.0 represents average volatility, lower numbers less volatility, and higher numbers greater volatility. (Stiglitz Direct at 41-42.)

Stiglitz used a beta for 20th Century in 1989 of 1.29 and for California utilities a beta of 0.475, yielding a difference of .815; multiplying his long-term (1929-1991) risk premium for the average equity (8.6 percent, the difference between the return of equities and Treasury bills over this period) by the .815 factor, Stiglitz inferred that 20th Century's risk premium in 1989 was 7.009 percent higher than the risk premium associated with California utilities. (Stiglitz Direct at 43-44.) He then added this 7.009 percent to the 13.0 percent rate of return for utilities in 1989, yielding a 20 percent return on equity for 20th Century. (Stiglitz Direct at 44.)

There are several flaws in Stiglitz' analysis up to this point. As discussed above, the Constitution permits a broad range of rates within the zone of reasonableness, whereas Proposition 103 as modified by *Calfarm* requires the Insurance Commissioner to set the rollback rates at or near the bottom of that range. By contrast, the 13 percent rate of return authorized by the California PUC in 1989 does not represent the minimum Constitutional rate, but rather the PUC's view of the appropriate point within the range of reasonable returns for utilities for that year.

Further, although agencies engaged in prospective ratemaking have considered the risk premium model or CAPM in ratemaking, in California the Public Utilities Commission ("PUC") has emphasized that this model should only be used as "a check" on other methods, and that while economic models may provide a good starting point for prospective ratemaking, ultimately the PUC must rely on its informed judgment. (*Re Southern California Water Co.* (1989) 30 CPUC 2d 635, 659.) Noting that "the results of these models are . . . highly dependent on the data timeframe selected," the PUC has said:

> "The Commission has previously considered these models and commented on their usefulness for ratemaking purposes. Essentially, the Commission has reservations regarding these models and places little weight on the results, but considers these useful to the extent that they provide a check." (*Application of Pacific Gas and Electric Co.* (1986) 23 CPUC 2d 149, 170, 1986 Cal. PUC Lexis 886 at p. 35.)

In the *RCD-2 Decision,* the Commissioner rejected the method of using the PUC-authorized rates of return for California utilities as a base and adding on to it to set rates for insurers because of differences between the industries:

> "A 10% rate of return is consistent with and maintains the historic relationship between returns in the property/casualty industry and other enterprises.

> While 10.0% is below the 1989 average returns earned by utilities and diversified financial firms, the evidence indicates that historically, property-casualty returns have consistently fallen below the level of returns in other industries. For example, between 1974 and 1989, a period characterized by ISO as comprising two complete 'underwriting cycles,' the property/casualty industry averaged a 10.8% return on GAAP equity. During that same period, the Fortune 500 averaged a 13.4% rate of return, 2.6% above the insurance industry. In the 1980s, while insurers were averaging a 10% return, utilities and banks averaged 12.8%, and diversified financial companies averaged 12.4%." (*RCD-2 Decision* at 17.)

The Department pointed out in its Opening Posthearing Brief that the RCD-2 proceeding considered several reasons for the fact that insurance companies consistently underperform utilities. (DOB at 65.) Unlike a utility or a manufacturer, whose capital is tied up in depreciating plant and equipment, an insurance company has nearly all of its equity in appreciating securities. Consequently, an investor can expect a much larger percentage of his or her return on an insurance company than on other investments to come from appreciation. Appreciation that is simply retained in form and not realized represents an increase in the value of the investment without appearing on the income statement. Thus, it is not surprising that insurers, while satisfying investors and attracting capital, book less income than other industries, where appreciating assets are a much smaller portion of the investment return. (*Idem.*) Respondent did not dispute that the RCD-2 proceeding considered these distinguishing features of the insurance industry, but simply treats them as irrelevant. (RRB at 32-33.)

The Department also points out that the ratemaking formula contained in the regulations captures realized capital gains but not unrealized capital gains, *i.e.*,—the appreciation of securities held by insurers and not sold.

(DOB at 65.) Consequently, when developing the appropriate rate of return for use under the regulations, the Commissioner took into account insurers' unrealized capital gains with a downward adjustment of 2.64%. (See *RCD-2 Decision* at 13.) Respondent's witness failed to address this aspect of the regulations. Respondent does not dispute this distinction but simply dismisses it as *de minimus*. (RRB AT 33.)

b. *Add-ons Further Raising the Rate of Return over 20 percent*

Stiglitz made further additions to the rate of return beyond the public utility rate adjusted by beta analysis, resulting in the addition of approximately 15 percent to the rate of return that 20th Century contends is constitutionally required. First, he added a risk premium of 3.4 percent for 20th Century's being a "small firm," bringing his figure to 23.4 percent. (Stiglitz Direct at 44.) Although the witness denied it, the small firm adjustment creates a risk of double-counting, since the beta that he relied upon as 20th Century's individual beta should have already captured 20th Century's riskiness as compared to the market in general. An empirically derived beta for a single firm purports to measure that firm's risk directly and thus should include all sources of its risk, including its size. The witness did not provide a satisfactory explanation why this adder was not duplicative of the enhancement that he had made already based on beta analysis. He admittedly had not studied the relationship between small firms' betas and other firms' betas, and did not know of any studies which related the magnitude of the small firm effect to the value of the beta. (RT 6 am at 12.) This risk of double-counting was not dispelled by the brief, cryptic excerpt offered by Respondent from Stiglitz' secondary textual source, suggesting that small firm betas do not completely account for their riskiness. (Res-45.) This hearsay excerpt is inconsistent with Stiglitz' explanation of beta analysis.

The witness originally defended the adjustment merely by pronouncing that "Twentieth Century is considered a small firm." (Stiglitz Direct at 44.) It turned out that he had no idea of the definition of "small firm" from which his 3.4 percent adjustment came. (RT 5 pm at 179-183.) Confronted with his lack of foundation for his opinions, the witness admitted to uncertainty and acknowledged that the small firm adjustment could be as low as one percent. (RT 5 pm at 184-88.)

The next day, the witness changed his testimony again, now advocating a new, larger small-firm adjustment based on a different justification. This new "small-firm" adjustment now embraced fully 70 percent of the stocks on the New York Stock Exchange as "small companies," and would result in an 8 percent upward adjustment. (RT 6 am at 13-27.) However, the new adjustment, by the witness' own admission, could not be used in conjunction with his non-small-firm figures because it was based on a different data set. (RT 6 am at 23-25.) Significantly, this "small-firm adjustment" was derived from NYSE stocks, even though 20th Century was not an NYSE stock during the relevant time period. The source upon which he relied expressly cautions that "*one should not assume that findings that hold for NYSE firms will hold for firms elsewhere.*" (RT 6 am at 56-57; CDI-135 [emphasis added].)

Stiglitz originally proposed two further "adders." One was for the increased risk that he found from what he believed to be the retroactive nature of the rollback, which he tentatively pegged at 5 percent. (Stiglitz Direct at 60-66.) 20th Century appears to have abandoned this theory, having tendered no legal authority for such a risk premium and omitted it from its Posthearing Briefs. In any case, its premise regarding retroactivity is mistaken as set forth in Section III.D.1, below; the measurement is highly speculative; and it is unsupported by precedent. The other adder was supposed to compensate for forgoing

dividends in favor of retained earnings, on the theory that if 20th Century had paid higher dividends it would have increased its market value. (Stiglitz Direct at 49-51.) 20th Century appears to have abandoned this theory as well, making no mention of it in its Posthearing Briefs. No legal basis has been put forward for it, and it conflicts with Stiglitz' own admission that most investors view dividends as tax disfavored. (RT 9 pm at 171.)

iii. *Respondent's Event Studies*

Respondent also relied on "event studies" which attempted to extrapolate an additional cost of capital for 1989 (the marginal cost) from the purported effects of 20th Century's stock offering on May 13, 1986. In the 1986 offering, it sold approximately 3.6 million shares, raising $60 million for its original owners. (Stiglitz Direct at 47; Stiglitz-17.) Stiglitz theorized that the sale diluted the value of the old owners' stock, and therefore they needed an extra high return to compensate for this dilution beyond the twenty to thirty percent that he had already advocated.

Before addressing the studies' numerous flaws, the inconsistencies in Stiglitz' testimony and the ultimately unsuccessful attempts on his redirect examination to plug the gaping holes that opened up during his cross, we note two basic problems with this theory. The first is that the investors who bought stock at the time of the issuance are more recently would reap the benefit of the proposed higher rate of return without the rationale (compensation for dilution of the value of shares held *prior* to the issuance)—at the ratepayers' expense. (See RT 9 am at 23.)

The second, more fundamental problem with this evidence is that it is offered to show 20th Century's *1989* cost of capital, yet it pertains to a *1986* event. Its staleness seriously undermines its value, especially under the

circumstances here. Until early 1986, 20th Century stock had only been sold over the counter and was not listed on any stock exchange. (RT 5 pm at 183.) From 1986 to 1991, it went from a $500 million to a $1 billion firm. (RT 5 pm at 184.) By the witness' own admission, in 1986 the stock did not represent a "seasoned" offering, while today it is seasoned. (RT 9 am at 19.) Therefore, it cannot be assumed that 20th Century's cost of capital in 1986 (even if established by the evidence) measures its 1989 cost of capital.

Further, even if the evidence of 20 Century's 1986 stock offering were relevant to its 1989 cost of capital, there were numerous flaws in the methodology employed. The most serious was its extreme susceptibility to manipulation by the choice of assumptions regarding the event starting and finishing date.

a. The First Event Study

The initial event study presented in Stiglitz prefiled direct testimony was based on a comparison of the daily changes in 20th Century's stock (plus dividends) to daily changes in the NASDAQ insurer index. (RT 6 pm at 100-01.) As a base period for comparison, he took a 30-trading-day period from March 19 through April 30, which he assumed represented a period when the relationship between 20th Century's stock and the NASDAQ index was uninfluenced by the impending stock issuance. (Stiglitz-17; RT 6 pm at 102.) Employing a regression analysis, Stiglitz derived an equation to represent the movement in 20th Century's stock during the 30 trading days as a function of movement in the NASDAQ index. (RT 6 pm at 106-110.) He then used that equation to project hypothetical 20th Century stock prices to year-end 1986, and compared that projection to the company's actual movement. Comparing the year-end results with his projections, he claimed that the difference was attributable entirely to the stock issuance. (RT 6 pm at

110.) He concluded that because of the stock issuance, 20th Century lost $121 million in value (equivalent to 24.22 percent of its value). (Stiglitz-17 at p. 4; RT 6 pm at 111.)

The record shows that the witness' direct testimony was entirely dependent on the period selected for the regression, with a change of one or two days dramatically altering the results. Using a 31-day period instead of a 30-day period produces an *increase* in the company's value of 3 percent, rather than a reduction of 24 percent. (CDI-117.) Conversely, a 29-day period produces a drop in value of over half due to the stock sale. (CDI-150; RT 9 am at 49.) Moreover, at the time that he originally sponsored the testimony, Stiglitz could not really explain why that particular 30-day period was chosen, nor attest to its correctness. (RT 6 pm at 130-31, 142-46.)

b. *The Second Event Study*

A twelve-day delay in the hearing occasioned by the temporary disapproval of the regulations by the Office of Administrative Law gave the witness an opportunity to attempt to resuscitate his analysis by working with consultants to come up with new statistical calculations amounting to a second event study. On February 4, he testified on this new "event study," which purported to show—despite numerous differences in the analysis—roughly the same (albeit slightly reduced) result: that 20th Century's value fell due to the 1986 stock sale by an amount now estimated at $100 million (or $80 million using a more conservative technique [RT 8 pm at 147-48]), plus or minus about $60 million. (RT 8 pm at 126.)

The differences between the first and the second event study were dramatic. They included:

—a redefinition of the time period during which he contended that the market responded to the stock sale from the original May 1 to December 31 period to a

new period of April 30 to May 13 (compare Stiglitz Direct with RT 9 am at 25-26);

—a change in the market response period selected from 245 calendar days to 14 calendar days (compare Stiglitz Direct with RT 9 am at 26);

—an extension of the regression period from 30 trading day to approximately 200 to 230 trading days (compare Stiglitz Direct with RT 9 am at 26);

—a change in the nature of the regression period from "before" the market response to a combination "before-and-after" the market response period (compare Stiglitz Direct with RT 9 am at 26);

—an expansion of the dependent variables selected from daily changes to include absolute price levels and dummy variables as well (compare Stiglitz Direct with RT 9 am at 29-30);

—a difference in the level of statistical significance from approximately 83 percent to 90 percent (compare Stiglitz Direct with RT 9 am at 35-38);

—a shortening of the period assumed necessary for the stockholders to recover from the dilution effect of the stock sale from 7 to 5 years (compare Stiglitz Direct with RT 9 am at 39-40); and

—an increase in the interest calculation for the recovery period by changing from simple to compound interest (compare Stiglitz Direct with RT 9 am at 40-41).

Despite these extensive modifications, the second event study presented on Stiglitz' redirect did not cure the most glaring defect of the first event study—the extreme variations in the results according to the time period selected. Although Stiglitz confirmed that the 29-day regression period was consistent with his methodology and would have been appropriate (RT 8 pm at 171-72; RT 9 am at 44-46), he claimed to have chosen 30 days over 29 because the loss of a single day would have produced a

larger standard deviation, and therefore a less accurate prediction. (RT 9 am at 46, 49-50.) In fact, when the 29-day regression run was ultimately produced by Respondent from its consultants' workpapers, it did not show a larger standard deviation than the 30-day run. (Compare CDI-150 and CDI-146; RT 9 am at 54). This disproved the witness' claim that shortening the number of days in his event study necessarily reduces the reliability of the pre-regression period. (RT 9 am at 49-50.)

Moreover, the 29-day run produced a vastly *larger* result—an indicated lost value of $290 million (CDI-150), which was over half the value of the company. (RT 9 am at 49.) Even Stiglitz agreed that this figure—the result of his own colleagues' application of the methodology that he continued to defend—was not "credible." (RT 9 am at 49.) The fact that a one-day change in the time period selected yields such dramatically different and patently implausible results, even though it has the same (or lower) standard deviation, illustrates the unreliability of the methodology.

The selection of the period to which the price effects of the stock offering were attributed was critical to the results of the event study. And the selection was plainly not based on any neutral economic principle but rather on the results that 20th Century wanted to achieve. For example, despite the fact that news of the pending stock offering was publicly reported in the *Los Angeles Times* as early as April 1 (CDI-123), 44 days before the May 13 issuance, Stiglitz assumed no discounting by the market during April and discarded only the last 14 days before the issuance as contaminated by what he assumed was the market's sudden discounting of the event. (RT 6 pm at 104-105.) While Stiglitz insisted that he had tested other dates and periods, the record shows that his diligence in searching for the effects of the stock issuance was not matched by an equally thorough examination of any other "event" which might account for some or

all of the stock price movement that he attributed to the stock-sale event. (RT 9 pm at 120-23.) Indeed, he conceded that his examination was constrained by his own "predisposition" of what and when the market response to the stock sale would be. (RT 9 pm at 101.)

Further casting doubt on Stiglitz' interpretation is the fact that the relatively sharp decline in 20th Century's stock immediately before the May 13 sale was followed by nearly as sharp a rise in the stock price's movement immediately after the May 13 sale, charting a U-shaped valley when graphed. (See CDI-153.) Stiglitz opined that the left slop of the U—the price drop—was attributable to the stock issuance and the right slope of the U—the climb back up—was not. (RT 9 pm at 86.) Respondent notes that after the upward movement that occurred immediately after the stock issuance, the stock went down again. Stiglitz testified that in the down-up-down motion of the stock, the first and second downward movements were caused by the stock issuance, and the rebound in between was "just part of the noise in the data." (RT 9 pm at 108.) However, this was an assumption not tested by a thorough statistical analysis, since although Stiglitz testified to longer tests, he never tested the upward-sloping side of the U by itself. (RT 9 pm at 96.) He claimed not to know whether application of his dummy variable technique to that side alone showed statistical significance, and could not say that it did not. (RT 9 pm at 108.) Apparently, he let the predisposition that he acknowledged rather than analysis be his guide. This undermines his dismissal of the upward movement at the time of the issuance as mere "noise."

The witness' interpretation of these statistical analyses was also based on dubious, unproven assumptions. The regression runs can only identify days on which 20th Century's stock movement was greater than one would expect from random movement; it cannot tell what caused them to move in that fashion. (RT 9 pm at 98-99.) The studies assumed that the NASDAQ index captured

the effects of all events that would influence insurers' stock generally (even though admittedly the NASDAQ index only explained about 35 percent of the movement in 20th Century's stock (RT 9 pm at 126)), leaving only 20th Century-specific events to consider. Yet, 20th Century-specific events were not thoroughly examined. For example, Stiglitz dismissed out of hand the potential impact of an announcement on April 8 that, in addition to selling new shares, the founder and president of the company and four other insiders were planning to sell several thousand of their own shares of the company (CDI-125 at p. 2),[28] as not possibly connected to the observed drop in the stock's price. (RT 6 pm at 160-63.) He also summarily dismissed an April 1 announcement that 20th Century had suffered a fourth-quarter 1985 loss of $3.6 million as unrelated. (RT 6 pm at 157.)

The underlying assumption that the NASDAQ insurance index would adequately detect general industry influences also proved to rest on a weak foundation. The NASDAQ index is a national index composed of both property-casualty and health and life companies. (RT 9 pm at 127-29.) Therefore, it is not as likely as 20th Century stock to react as sharply to events that had a particular effect on California insurers, especially California insurers like 20th Century which specialize in personal lines property-casualty insurance. Yet the time of the stock issuance was also a time when Californians felt themselves in the grip of a liability crisis. Proposition 51, the first tort-reform initiative, was on the ballot (RT 9 pm at 130), to be voted on three weeks after the 20th Century offering. The gubernatorial election campaign was underway, and on April 30—the day that Stiglitz claims the market began to respond to the prospective sale of 20th Century stock—the *Los Angeles Times* reported

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[28] They later changed their minds and retained their shares. However, no evidence was introduced showing whether and if so when and how this information was announced to the public.

that the anticipated Democratic candidate (Mayor Bradley of Los Angeles) vowed to take strong action to control insurance prices and extent insurance coverage. (CDI-147; see also CDI-148.)

Stiglitz dismissed such events as potential causes of the drop in 20th Century's price. (RT 9 pm at 129-134.) But he did not study the movement of the other stock company specializing in California personal-line insurance, Mercury. In fact, the movement of Mercury's stock was strikingly similar to 20th Century's during the relevant period. (CDI-144; RT 9 pm at 134-37.) Confronted with this fact, the witness speculated that *Mercury's* stock price movement was due to *20th Century's* stock sale (RT 9 pm at 137), because of their presumed high cross-elasticity of demand. No evidence was introduced to support his speculation.

The piling on of untested assumption upon assumption, combined with the result-driven selection of time periods, simply made the witness' opinion not credible.[29] In short, despite heroic efforts to save the event study, all the king's horses and all the king's men couldn't put Humpty together again. (Anon.)[30]

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[29] Professor Stiglitz' frequent failure on cross-examination squarely to answer questions capable of a yes or no answer with a straightforward response, engaging instead in nonresponsive digressions, further undermined the credibility of his testimony. His $450 an hour fee is noteworthy even in the well-paid field of economic experts.

[30] Underlying the event study is a static economic equilibrium model which holds that when new stock is issued, the value of the holdings of the prior stockholders is diluted by the increased supply of stock which lowers the price. However, competing theories are also plausible and have their adherents among economists. For example, as Stiglitz acknowledged, another theory published in the literature holds that stock issuances occur when management believes that the stock is overvalued, and that the market's awareness of this accounts for the drop in price. (RT 9 am at 11-12.) While Stiglitz did not subscribe to this theory, it is interesting to note that 20th Century's price had experienced a large increase in the prior year. (CDI-145.) Also, its founder and

D. *Respondent's Argument that the Expense Disallowances in the Rollback Calculation Are Unconstitutional*

1. *The Substantive Due Process Claim*

Respondent argues that the regulations operate arbitrarily and capriciously in that they retroactively disallow business expenses which were prudently made by 20th Century, thereby depriving it of substantive due process. It complains that when it made the expenditures it had no notice that they would be disallowed. It also argues that the regulations violate the California Constitution because they impair vested property rights without due process of law. (ROB at 63-66.) The Department responds that the regulations are not retroactive as defined by established case law, and that even if they were retroactive they are still lawful. (DRB at 43-49.)

20th Century's expense disallowances do not violate due process for several reasons. First, a due process violation only occurs in the extreme situation where the results are arbitrary and capricious "bearing no relation to the police power" (*Eastlake v. Forest City Enterprises, Inc.* (1976) 426 U.S. 668, 675-76 and n.10, 96 S.Ct. 2358) and are "wholly unexpected" and "oppressive." (*Morseburg v. Balyon* (9th Cir. 1980) 621 F.2d 972 (cited by Respondent [ROB at 64].) *Morseburg* found no due process violation in the application of a statute requiring royalty payments to artists of 5 percent of the proceeds upon resale of their work to an art dealer who purchased an artist's paintings before the statute passed but who resold the paintings after the statute took effect. (*Id* at 979-80.) In effect, the law changed the economic

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other insiders initially announced publicly that they would sell some of their own stock. (CDI-125 at 2.) Although they later changed their mind, no evidence was introduced as to when and how this change was made public. Under this alternative theory, there is no theoretical justification at all for allowing an extra rate of return to 20th Century based on the stock issuance.

consequences of the dealer's economic transaction made before the law to his detriment, forcing him to pay more to the artist than he had originally bargained for and receiving a lower profit margin on the resale than he expected at the time that he purchased the art. The Court observed that whether the statute was "retroactive" was arguable since it only applied to sales made after its passage. (*Id.* at 980.) The Court went on to hold that, even assuming that the statute was retroactive, it was still valid because:

> " '*legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations.* Many laws upset some expectations regarding the legal consequences of prior conduct. . . . [O]nly when such retroactive effects [of a law] are so *wholly unexpected and disruptive that harsh and oppressive consequences follow* is the Constitutional limitation [of the due process clause] exceeded." (*Id.* at 980 [citations omitted; emphasis added].)

Therefore, the issue of whether the expense disallowances under the regulations are better characterized as "prospective" or "retroactive" in the technical sense that the cases use those terms is not determinative, since they do not violate due process under either label. The expense disallowances may properly be considered prospective since Proposition 103 as originally enacted was prospective and as modified by *Calfarm* remained so, because the Court forewarned insurers of their potential liability for refunds if they chose not to rollback rates to the statutory amount and were later found to have charged more than the constitutional minimum. (48 Cal. 3d at 815; *cf. Consumers Lobby Against Monopolies v. Public Utilities Commission* (1980) 25 Cal.3d 891, 899, 910, 160 Cal.Rptr. 124 [refunds eventually required were "prospective in nature" when PUC allowed utility to impose certain charges on customers subject to possible refund if PUC later decided to reinstate a decision elim-

inating such charges]; *Southern California Gas Co. v. Public Utilities Commission* (1985) 38 Cal.3d 64, 67, 211 Cal.Rptr. 99 [statute awarding attorney fees for work in proceedings occurring before its enactment not retroactive because no final awards made before its effective date; "to the extent awards have been deferred, the new statute has no true 'retroactive' effect at all. It simply applies prospectively to all awards hereafter made, or made final, in proceedings commenced before January 1, 1985."]; *Lee v. Board of Civil Service Commissioners* (1990) 221 Cal.App.3d 103, 112, 270 Cal.Rptr. 47 [application to pending case of an agency's new interpretation correcting a past erroneous interpretation not retroactive].).

However, even if the expense disallowances are assumed to be properly characterized as "retroactive," the effect on 20th Century is not so harsh and so wholly unexpected as to violate substantive due process. As discussed in Sections II.C and II.J, above, 20th Century's expense disallowances are relatively modest. Expenses not allowed in the ratemaking formula pursuant to the efficiency standard under § 2644.12 are $126,235, and those excluded on public policy grounds (bad faith judgments, excess executive compensation, etc.) under § 2644.10 are $589,186. (See ALJ-20). Compared to 20th Century's direct earned premiums of $641.7 million, the exclusion of $715,421 (or 0.1 percent) is not harsh and oppressive.

Nor does the treatment of reinsurance premiums violate substantive due process. As explained in Section II.D, above, far from being an arbitrary method unrelated to the police power, the consistent use of direct ratemaking, which does not look at reinsurance premiums or recoveries, is an entirely proper and rational accounting method widely used in the insurance industry. Although the impact of 20th Century's rollback obligation is not insubstantial, it is still not unnecessarily harsh and oppressive when viewed in relation to total premiums, especially

in light of the compelling need for consistent accounting treatment.

Further, Respondent's reduction in rates including the expense disallowances is not the type of "wholly unexpected" disruption of settled expectations that may give rise to a deprivation of due process. (*See Morseburg, supra*, 621 F.2d at 980.) As of November, 1988, Respondent knew full well that the voters' had enacted Proposition 103 with its provision for a 20 percent reduction in rates. As *Calfarm* noted in the course of rejecting a contract clause challenge to Proposition 103's mandatory renewal provision:

> "Insurance is a highly regulated industry, and one in which further regulation can reasonably be anticipated. . . Indeed it is clear that during the year prior to November 8, 1988 . . . insurers were well aware of the possibility that initiatives . . . might be enacted that would affect existing policies." (48 Cal.3d at 830-31 [citations and footnote omitted].)

Although Respondent may well have hoped that the California Supreme Court would eliminate completely the rate reductions mandated by Proposition 103, Respondent hardly could hold a settled expectation that it would do so, particularly in view of longstanding precedent favoring the validity of statutes and initiatives. (*See Calfarm*, 48 Cal.3d at 814, for a summary of that precedent.) Thus, Respondent had notice that if it chose not to comply with the rollback provision immediately, it risked having to refund premiums to consumers based on a future rate determination by the Insurance Commissioner. *Calfarm* gave insurers a choice of reducing the rates to statutory rollback levels or applying for permission to charge a higher rate and charging that rate subject to "*refund with interest of any premiums collected in excess of the rates ultimately approved.*" (*Id.* at 815 [emphasis added].) Thus, 20th Century was on notice that it potentially could be subjected to a rate rollback up to 20

percent, depending on the minimum nonconfiscatory level. The refund here, even after the expense disallowances, is substantially below the 20 percent rollback of which it had notice in 1988.

Nor is Respondent's related argument that application of the regulations impairs vested property rights without due process well taken. (ROB at 65.) *Graczyk v. Worker's Comp. Appeals Bd.* (1986) 184 Cal.App.3d 997, 229 Cal.Rptr. 494, cited by Respondent, teaches that:

> " 'The retroactive operation of a civil statute is by no means unusual, and no constitutional objection exists to such operation save where a vested right, or the obligation of a contract, is impaired.' " (*Id.* at 1002 [citations omitted].)

Further, even vested property rights are not immune from impairment where a government agency reasonably believes the impairment to be necessary to public welfare:

> " 'Vested rights are not immutable; the state, exercising its police power may impair such rights when considered reasonably necessary to protect the health, safety, morals and general welfare of the people.' Hence, the constitutional question, on principle, is not whether a vested right is impaired by a change of law, but whether such a change reasonably could be believed sufficiently necessary to the public welfare as to justify the impairment." (*Id.* at 1008 [citations omitted].)

In the first place, it does not appear that Respondent has any vested right under California law immunizing it from the rollback formula by virtue of having made certain expenditures. (*See, e.g., Avco Community Developers, Inc. v. South Coast Regional Coastal Commission* (1976) 17 Cal.3d 785, 553 P.2d 546, 132 Cal.Rptr. 386 [over $2 million spent in reliance on a grading permit only gave developer a vested right to grade dirt, not to complete construction]; *Raley v. California Tahoe Re-*

gional Planning Agency (1977) 68 Cal.App.3d. 965, 137 Cal.Rptr. 699; *Anderson v. City Council* (1964) 229 Cal.App.2d 79, 89, 40 Cal.Rptr. 41 ["the vested rights theory is predicated upon estoppel of the governing body . . . . (absent issuance of a building permit] it is difficult to conceive of any basis for such estoppel" even though property owners had purchased property in reliance on existing zoning law and made certain improvements before applying for a building permit].) Notably, Respondent's brief fails to cite any legal precedent in support of its assumption that it has a vested right.

Second, even assuming *arguendo* that Respondent does have a vested right and that the regulations are properly characterized as "retroactive," there is no constitutional defect under the factors set forth by *Graczyk,* which address the significance of the state's interest in retroactivity of the new law as compared to the degree and legitimacy of any reliance on the former law. (184 Cal.App.3d at 1008.) The state has a very significant state interest in enforcing the rollback obligation that is the law of this state. Under Proposition 103 as interpreted by *Calfarm,* whenever the Commissioner finds that an insurer charged more than the minimum nonconfiscatory rate in 1989, the law mandates a refund to consumers of the difference; and Respondent could not legitimately rely upon pre-Proposition 103 law to assume that any expenditures it made in the rollback year would pass through permanently to its insureds.

The United States Supreme Court recently upheld the retroactive application of a statute which required companies to refund workers' compensation benefits withheld in reliance on prior law against a due process challenge, based on the established rule that retroactive legislation satisfies the due process clause so long as it represents "'a legitimate legislative purpose furthered by rational means.'" (*General Motors Corp. v. Romein, supra,* 503 U.S. ——, 112 S.Ct. at 1112, 1992 U.S. LEXIS 1535 [citation omitted].) Here, even if the regulations are

viewed as retroactive, they further the legitimate legislative purpose of lowering insurance rates by the rational means of reducing expenses charged to consumers that the Commissioner finds unnecessary.[31]

2. *The Taking Claim*

Respondent also attacks the expense disallowances as violating the Takings Clause of the United States Constitution. It argues that all properly incurred expenses must be allowed, and further that since the Commissioner determined that the constitutional minimum rate of return is 10 percent, any disallowance must place its effective rate of return below the constitutional minimum. (ROB at 66-68.) However, disallowance of investments that were prudent at the time that they were made because they turned out not to be "used and useful" has been upheld against constitutional attack. (*See, e.g., Duquesne Light Co. v. Barasch, supra,* 488 U.S. at 301-02, 109 S.Ct. 609, 612; *Jersey Central Power & Light v. F.E.R.C., supra,* 810 F.2d at 1181 n. 3 ["absent the sort of deep financial hardship described in *Hope,* there is no taking, and hence no obligation to compensate, just because a prudent investment has failed. . . ."].) 20th Century attempts to distinguish *Duquesne Light Co.* and similar cases on the ground that the overall effect there was not confiscatory, whereas here, it argues, the Commissioner has determined that anything below 10 percent is confiscatory and the disallowances result in a rate below 10 percent. However,

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[31] The other case cited by respondent (ROB at 65), *In Re Marriage of Fabian* (1986) 41 Cal.3d 440, 224 Cal.Rptr. 333, is not on point. Unlike here, where Respondent had notice of Proposition 103 before making any expenditures and collecting premiums in the rollback year, in *Fabian* the issue was the retroactive application of a statute changing community property law to a couple whose judgment of dissolution had been rendered one and a half years earlier. (41 Cal.3d at 448.) Further, the Court noted the special public policy reasons against disruption of the law governing marital dissolutions. (*Id.* at 450.)

as the Department notes, the Commissioner knew when he set the 10 percent rate that certain expenses would be disallowed as contemplated in the same regulations, and he found the 10 percent rate of return to be constitutional in conjunction with such disallowances.

E. *The First Amendment and Equal Protection Challenges*

Respondent raises for the first time in its opening brief, seemingly as an afterthought, the arguments that the regulations violate its free speech and equal protection rights under the federal and state Constitutions. These arguments are contrary to well-settled principles of constitutional law.

Respondent claims that a First Amendment violation inheres in the regulations' requirement that stockholders, not policyholders, pay its expenses for political contributions and lobbying and institutional advertising. (Regulations, § 2644.10(a), (f).) Respondent expended approximately $100,000 in 1989 in these categories, most of which ($82,000) was for political expenses. (See, e.g., ALJ-1 [at exhibit 4.A.2. thereto].) Respondent contends that the disallowance of these expenditures is an unconstitutional penalty on its speech. While the Constitution may well protect the right to engage in such activities,[32] it does not require policyholders to pay for them. The requirement that shareholders pay such costs, rather than policyholders who have no say in the political positions taken or institutional messages chosen by the company, hardly constitutes a penalty. (*Cf. Rust v. Sullivan* (1991) —— U.S. ——, 111 S.Ct. 1759, 1991 U.S. Lexis 2908, slip. op. at 35, 40 [" 'A refusal to fund protected activity, without more, cannot be equated with the imposition of a 'penalty' on that activity' " and "[A] legislative decision

[32] It is not necessary to discuss the scope of such protection here, since the right to engage in such activities is not affected by the regulations.

not to subsidize a fundamental right does not infringe the right' "; regulations forbidding speech about abortion in family planning clinics receiving federal funds not impermissible viewpoint discrimination and "do not force the [recipient of the subsidy] to give up abortion-related speech" (citations omitted)]; L. Tribe, *American Constitutional Law,* § 11-5, p. 782 (2d ed. 1988) ["the fact that government may not penalize exercise of a right . . . does not imply that government must subsidize exercise of the right"].)

The California Supreme Court approved the similar practice by the California PUC of excluding political expenditures from utility rates, agreeing with the PUC that "the cost of legislative advocacy should not be passed on to the ratepayers." (*See Pacific Tel. & Tel. Co. v. Public Util. Comm'n* (1965) 62 Cal.2d 634, 670, 44 Cal.Rptr. 1.) While the company there did not attack the disallowance on free speech grounds, the PUC's reasoning that ratepayers should not be required to pay for political advocacy when they have no opportunity to choose what is advocated applies here as well. (*Ibid.*)[33]

The two equal protection claims that Respondent raises are frivolous. The first boils down to a claim that the Commissioner has somehow singled out insurers by not regulating industries outside his jurisdiction, and is simply an attempt to recast the invalid First Amendment argument into an equal protection claim. (ROB at 72.) In any case, insurers are not alone; as noted above, the PUC similarly has not allowed the companies that it regulates to shift the bill for their political speech to their customers.

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[33] If there were any first amendment issue here, it would be whether consumers have a right not to subsidize political speech by insurers with which they may well disagree. That would arguably be the type of forced subsidy of speech with which one disagrees that has increasingly concerned the United States Supreme Court. (*Cf., e.g., Keller v. State Bar* (1990) 496 U.S. 1, 110 S.Ct. 2228; *Abood v. Detroit Board of Education* (1977) 431 U.S. 209, 97 S.Ct. 1782.)

The other equal protection claim, mentioned only in two lines in footnotes purporting to preserve the issue for judicial review, is that the trimodal efficiency standard somehow violates the equal protection guarantees of the state and federal Constitutions. (ROB at 64 n.4, 68 n.6.) Under both the federal and state equal protection provisions, it is hornbook law that "the classification need only bear a rational relationship to a conceivable legitimate state purpose." (*People v. Boulerice* (April 9, 1992) —— Cal. App.3d ——, 1992 Cal.App.Lexis 479, 11, 92 C.D.O.S. 3135, 3136-37.)[34] The trimodal efficiency standard easily passes this test. It employs a rational classification based on the industry's use of three distinct methods of distribution (direct writing, use of captive agents and use of independent agents), and is rationally related to the legitimate purpose of reflecting in the rate structure the three methods' undisputed differences in costs and modes of service. (RT 2 night at 259; RT 2 pm at 144.)

The lone equal protection case cited by Respondent, *Britt v. City of Pomona* (1990) 223 Cal.App.3d 265, 272 Cal.Rptr. 724, is not on point. It concerned an irrational taxation scheme which distinguished without justification between different types of transients, permitting some to escape the tax while others had to pay, and between those dwelling in certain designated types of shelter and residents in apartments, houses and boarding homes. (*Cf. Pennell v. City of San Jose* (1988) 485 U.S. 1, 14-15, 108 S.Ct. at 859 [rejecting equal protection challenge to rent control ordinance scheme which more strictly con-

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[34] This relaxed rational basis test applies even if the provision challenged has an "incidental effect on the exercise of protected rights . . ." and strict scrutiny is only required when the scheme results in a "real and appreciable impact on, or a significant interference with, the exercise of a fundamental right." (*People v. Boulerice, supra,* 1992 Cal.App.Lexis 479, 11-12, 92 C.D.O.S. at 3137.) Respondent has not argued that strict scrutiny applies here, nor could it.

trolled rents of landlords whose tenants would face a hardship from a rent increase than rents of other landlords as rationally related to legitimate state purpose].)

F. *Respondent's Argument that the Rollback Violates the Statute by Purportedly Exceeding 20 Percent In Some Lines*

Respondent raised for the first time in its Posthearing Reply Brief the argument that the rollback formula reduces rates for three of its lines by more than 20 percent in violation of the statute: the Earthquake line (allegedly reduced by 89 percent), Inland Marine (allegedly reduced by 91.2 percent), Other Liability (allegedly reduced by 99.9 percent) and Auto Physical Damage (allegedly reduced by 25.6 percent).[35] Respondent points to Proposition 103's provisions that "rates" and "charges" for property-casualty insurance coverage in general and for automobile insurance policies in particular should be reduced by 20 percent from the rates charged as of November 8, 1987. (Ins. Code §§ 1861.02(a), 1861.02(d).)[36]

As explained in Section II.D, above, the line-by-line calculations are only interim steps in determining the rollback year rates. The end result is that the rollback reductions are capped at 12.203 percent in each line including earthquake, almost 8 percentage points *less* than 20 percent. This is consistent with the language of Proposition 103 as interpreted by *Calfarm*. Accordingly, this attack

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[35] 20th Century's argument that the rollback in Auto Physical Damage improperly exceeds 20 percent (RRB at 66) may well be mooted by the adoption of 20th Century's proposal to combine lines for purposes of the efficiency standards. In any case, we consider it to be without merit for the reasons explained above.

[36] The language of Proposition 103 upon which respondent relies, contained in subsections (a) and (d) of section 1861.01, undercuts respondent's argument that a close parsing of line by line charges is required in its emphasis on an across-the-board 20 percent reduction in consumer payments and its use of general words like policies and coverage.

on the rollback calculations as violating the statute is misplaced.

This argument is apparently proffered as a statutory challenge. However, to the degree that it is also raised as a constitutional issue, it fails. The constitutional issue is the extent to which the 20 percent statutory reduction in rates must be changed to avoid confiscation. The cases teach that confiscation is an enterprise-wide issue, not one to be parsed on a line-by-line basis. (*See, e.g., Hope,* 320 U.S. at 603 [constitutional test involves the "financial integrity of the *company whose rates are being regulated*" (emphasis supplied)]; *Baltimore & Ohio RR Co. v. United States* (1953) 345 U.S. 146, 150 [no taking where rates allowed railroad for hauling certain vegetables on some lines were too low to cover the costs of the shipments, because "[S]o long as rates as a whole afford railroads just compensation for their over-all services to the public the Due Process Clause should not be construed as a bar to the fixing of noncompensatory rates for carrying some commodities when the public interest is thereby served."]; *Market St. Ry. Co. v. Railroad Com.* (1944) 24 Cal.2d 378, 397, *aff'd* (1945) 324 U.S. 548, 565, 65 S.Ct. 770 [unreasonableness of rates turns on whether 'the end result' of the commission's order interferes with the company's successful operation, its financial integrity, its ability to maintain credit and attract capital, and to compensate investors for the risk assumed"].)

G. *The Inclusion of Investment Income in the Calculation of Rate of Return*

Respondent raised for the first time in its Posthearing Reply Brief an objection to the inclusion of investment income on surplus in the calculation of its rate of return, advocating that only income earned on policyholder's reserves should be included. (RRB at 61-65.)[37] This is a

[37] Rather than simply refusing to consider an issue raised for the first time in a reply brief, the Administrative Law Judge

transparent attempt to relitigate an issue resolved by the regulations, which adopted the method of total rate of return ratemaking.

The Department points out that, unlike other businesses such as public utilities, insurers need not transform their capital into physical assets like a power plant, but may keep them instead in liquid assets like stocks and bonds. Surplus may simultaneously support the insurance business and earn investment income. To ignore investment income would result in an actual rate of return far in excess of the 10 percent determined by the Commissioner to be the constitutional minimum rate of return.

H. *The Commissioner's Authority to Promulgate the Rollback Regulations*

20th Century argues that the rollback regulations exceed the Commissioner's statutory authority and run afoul of Proposition 103's provision for individual adjudicatory hearings. (See Ins. Code § 1861.08 [incorporating many provisions of the Administrative Procedure Act].) However, in *Calfarm* the California Supreme Court considered the Commissioner's authority to issue general regulations implementing Proposition 103 and reached a contrary conclusion:

> "Proposition 103 . . . . does not establish a detailed method of processing and deciding rate applications. . . . *Much is necessarily left to the Insurance Commissioner, who has broad discretion to adopt rules and regulations as necessary to promote the public welfare.* . . . . No provision bars the Commissioner

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asked for supplemental briefing on the issue. Respondent seized on this opportunity to introduce a new argument in its Supplemental Posthearing brief. It belatedly argued that the inclusion of investment earnings on surplus in the rollback formula creates a double taxation problem. The record is devoid of any evidence in support of this point, and in any case Respondent waived it by not raising it in a timely manner.

> from . . . issuing regulations of general applicability. Thus there is nothing here which prevents the Commissioner from taking whatever steps are necessary to reduce the job to manageable size." (48 Cal.3d at 824-825 [emphasis added.])

Moreover, the Supreme Court has recently recognized the Commissioner's special expertise in resolving complex ratemaking issues, citing the statement in *County of Los Angeles v. Farmers Ins. Exchange* (1982) 132 Cal.App. 3d 77, 87, that:

> " 'the Insurance Commissioner and the Department of Insurance possess sophisticated bodies of expertise in this field which make them particularly able to handle these matters.' " (*Farmers Ins. Exchange v. Superior Court* (April 6, 1992) slip.op. at 30, —— Cal.3d ——, 1992 Cal.Lexis 1364, 37.)

The regulations are an exercise of the Commissioner's broad discretion to adopt rules implementing Proposition 103 to promote the public welfare, and embody his expertise in this area. The regulations avoid the administrative breakdown that would result from adjudicating and readjudicating hundreds of issues that affect multiple insurers over and over again in endless individual hearings —hearings that would yield inconsistent results *if* they ever yielded any results at all. The regulations employ generic determinations and a detailed formula designed to ensure manageability and consistent treatment of insurers and insureds. At the same time, they tailor the results to individual insurers' situations by utilizing company-specific data on scores of different items, providing for variances and allowing consideration of new issues not litigated in the course of the adoption of the regulations and generic determinations.

The adjudicatory proceeding in which the regulations are applied provide a further opportunity for scrutinizing the company-specific application of the regulations, includ-

ing: determination of any variances; tailoring of the application of the regulations, as exemplified by the ULAE/ALAE reallocations reducing 20th Century's rollback made as a result of this hearing (see Section II.A, above); and consideration of issues not previously litigated, such as the application of the efficiency standard to combined automobile lines. Thus, 20th Century has not been deprived of a meaningful adjudicatory hearing as it asserts.[88]

20th Century also complains that the regulations violate Proposition 103 by placing the burden of proof on the insurer to prove that it is entitled to a lesser rollback, based on Respondent's view that it should only have to show that its rates are neither excessive nor inadequate. (ROB at 97-98.) This is a spurious distinction, as explained above in Section III.B. Under Proposition 103 as modified by *Calfarm*, the burden of establishing that its rates are not excessive or inadequate for the rollback year is the burden of establishing that the statutory rollback or the lesser reduction determined by the Commissioner is inadequate in the sense of being constitutionally confiscatory, and conversely that its rates were not excessive in the sense of exceeding the minimum nonconfiscatory rate.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

1. All findings in this decision shall be considered to be either findings of fact or conclusions of law. They should be read in conjunction with the "Discussion" section which further explains the reasons for our determinations in this matter.

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[88] 20th Century's claim that the hearing "exclud[ed] any direct evidence of constitutional entitlement to any rate other than that calculated in his regulations" (ROB at 98) is stunning. The record includes hundreds of pages, more than a week of testimony and dozens of exhibits that were admitted into evidence regarding its contention that it was entitled to higher rates based on its cost of capital.

Notice and Hearing

2. The hearing was full, fair, and allowed all parties a reasonable opportunity to present relevant evidence and argument.

3. The Notice and Amended Notices given to Respondent provided Respondent with full, fair, and adequate notice of the time, place, and subject matter of the hearing. Further, Prehearing Conferences and Orders, together with motions and briefing concerning the scope, timing, and procedural order of the hearing gave all parties reasonable notice of the issues and subject matter that would be covered by REB-5173.

4. All parties were provided with a full opportunity to cross-examine opposing witnesses within the framework of an orderly hearing.

5. Pursuant to title 10, chapter 5, subchapter 4.8 of the California Code of Regulations ("the regulations"), Respondent was given an opportunity to present extensive evidence on the minimum nonconfiscatory rate for the rollback period. Furthermore, pursuant to section 2646.4, subdivision (e), of the regulations, Respondent was given an opportunity to present evidence and argument on whether the rollback formula, as applied by the Department, yielded unconstitutional and confiscatory results as applied to 20th Century.

6. Respondent argues that it was denied a meaningful hearing including the opportunity to develop a full record on its statutory and constitutional challenge to the regulations as applied, an adequate opportunity to seek individualized relief, and a meaningful variance from the regulations.

7. The Commissioner finds as a matter of law that the regulations and hearing before the Administrative Law Judge provided Respondent an individualized computation of its rollback liability, based on the operating results and

circumstances uniquely applicable to Respondent. The Commissioner further finds that Respondent was accorded the opportunity to present evidence and to seek findings and determinations on every issue that it contended was material.

8. The Commissioner finds that Respondent has demonstrated no company-specific characteristics that justify or require departure from the regulations as they have been applied here.

9. At the first Prehearing Conference, Respondents requested permission to introduce evidence to show that the Department's rollback regulations, including the generic determination of the rate of return, are confiscatory as applied to 20th Century. Respondent was permitted to offer testimony and submit evidence regarding its company specific rate of return as an offer of proof to be ruled upon by the Administrative Law Judge.

10. Respondent submitted extensive testimony by three experts: Mr. Priest, a professor of law specializing in law and economics, Mr. Stiglitz, a professor of economics, and Mr. Crichfield, a management consulting partner of the firm Ernst and Young, as well as testimony by company officials directed toward the constitutional issues. At the second Prehearing Conference, there being no objection, this evidence was admitted.

11. Pursuant to this prefiled testimony, Priest put forward his constitutional and policy analysis that the Department's rate of return regulations were improper; Stiglitz presented expert economic and statistical opinion regarding the cost of capital, and Crichfield sponsored many (but not all) of the statistical calculations relied upon by Stiglitz for his opinion on 20th Century's cost of capital.

12. Stiglitz testified orally for five days, on additional direct supplementing his prefiled testimony, on cross, on redirect, and on additional rounds of recross and re-direct

examination. After his cross-examination, Stiglitz was permitted to testify extensively on redirect examination on January 23 and February 4. Respondent acknowledges that "Professor Stiglitz was permitted to present on redirect his thorough statistical rebuttal to the Department's cross." Stiglitz was permitted to go beyond the scope of his original direct testimony and beyond strict interpretation of the scope of cross-examination into new economic/statistical methodologies and studies designed to bolster his original conclusions and rebut any inferences suggested on cross-examination that his prior work was not credible. His redirect examination included rebuttal testimony to the Department's exhibits introduced during his cross-examination and introduced numerous new statistical and graphic exhibits offered by Respondent, involving topics such as new calculations and regression analyses, new methodologies, and new data.

13. Crichfield's original prefiled testimony, received by the Administrative Law Bureau on December 3, 1991, was admitted into evidence at the December 9 Prehearing Conference. Crichfield's direct testimony was almost entirely limited in scope to foundational data and calculations supporting certain specific aspects of Stiglitz' testimony. However, the declaration closed with one very general, conclusory paragraph criticizing the Department's generic regulation regarding rate of return and stating that it was too low for 20th Century. Although Crichfield noted that he wished to do further work if time permitted, he performed almost no additional work until after Stiglitz' cross-examination. Respondent did not propose additions to his testimony until almost twelve weeks after Crichfield's original testimony was filed.

14. The ALJ allowed Crichfield to supplement his original prefiled direct by admitting portions of his new prefiled testimony which elaborated on his qualifications and the scope of the work he performed in this case, and updated, corrected and expanded on his original testi-

mony. The admitted testimony elaborated on Crichfield's beta analysis comparing 20th Century's risks with other insurers and public utilities. Also admitted was his testimony criticizing the Department's Exhibits CDI-128 and CDI-129 regarding market share and HHI calculations. However, the ALJ excluded as cumulative and unduly repetitious portions of the proposed testimony relating to Stiglitz' cross-examination and redirect, such as Crichfield's conclusory expressions of agreement with techniques and analyses used by Stiglitz which neither Crichfield nor his firm had performed.

15. In addition to his original prefiled testimony, Priest testified on direct, cross-examination and redirect on December 19, 1991. Respondent's counsel predicted at that time that he had "at least another 20 minutes or so" of redirect remaining. Priest then departed for a family vacation. Thereafter, Respondent informed the ALJ and opposing parties that they were unlikely to call him for further redirect, although they had not made a final decision. In late February, however, Respondent stated that they intended to call him back for more extensive testimony when he was available on February 28. At that time, Priest was permitted to testify on 12 of 16 proposed additional questions. The ALJ excluded four proposed questions which concerned HHI analyses because they went beyond the scope of redirect and were unduly repetitious and cumulative of Stiglitz' and Crichfield's testimony on the same subject.

16. The Commisioner finds that Priest's testimony consists primarily of inadmissible legal opinion and irrelevant general policy criticisms of the wisdom of Proposition 103 and the regulations, rather than testimony on material facts.

17. The Commissioner finds that Priest's testimony seeks to relitigate the rate of return issues already determined in the generic proceedings. Priest's prefiled direct

testimony is in large part identical to his "Comment on Proposed Regulations" dated January 10, 1991, entitled "the Effects of Proposition 103 on Consumers and on Competition in Property/Casualty Insurance," filed in the general rulemaking proceedings RH-291 which led to the rollback regulations. The Commissioner previously has considered, and rejected, much of this testimony.

18. The Department did not call any expert witness to rebut the testimony of Respondent's experts on the constitutional and statutory issues.

19. The Commissioner finds as a matter of law that Respondent was accorded the opportunity to develop a full record on its constitutional claims in light of the extensive testimony of Respondent's witnesses.

20. These proceedings were commenced under the Commissioner's emergency regulations ER-19a issued as a result of rulemaking proceeding RH-291. The ER-19a regulations expired on January 15, 1992, whereupon the Office of Administrative Law (OAL) refused to accept those regulations for filing on a permanent basis. OAL also refused to accept replacement regulations ER-19c for filing on an emergency basis, thus temporarily leaving no regulations in force. On February 14, 1992, Governor Pete Wilson overrode OAL's decision and ordered the emergency regulations ER-19c accepted for filing.

21. The Commissioner finds that the ER-19a and ER-19c regulations and the rollback standards applicable to Respondent pursuant to those regulations were substantially the same, having only minor differences that did not affect the scope of the hearing. In fact, the amendment to section 2646.4(e) merely made explicit the procedure that had already been followed in this hearing prior to the amendment by specifying that relevant evidence may be admitted even though not specifically contemplated by other provisions of the regulations, provided that it was not offered to relitigate previously determined matters.

During the brief period of time when no regulations were in effect, the only testimony heard was from Joseph Stiglitz on the statutory and constitutional issues. His testimony was primarily directed toward disputing application to Respondent of the rate of return determined by RCD-2 (which was not the subject of the OAL's action), and was not affected at all by the minor revisions to the regulations. Proceeding with the hearing during this period prejudiced no party, required no testimony or witness to be withdrawn or revised, and did not impede the orderly process of the hearing.

TECHNICAL ISSUES

22. On technical issues, testimony was presented for Respondent by Charles Petit, James Curley, John Bollington, and Wallace Voss and for the Department by Robert Hunter. The opinions of the Department's expert Hunter are entitled to great weight in view of his impressive credentials in insurance regulations and ratemaking and his forthright demeanor throughout the hearings. We were also generally favorably impressed by Respondent's company official witnesses, Petit, Curley, Bollington and Voss, whose testimony was for the most part credible, except for some instances when their opinions and conclusions were unduly colored by their desire to minimize the amount of Respondent's rollback obligation.

The Adjustment of Expenses Reported as ULAE to ALAE

23. Traditionally, most insurance companies retain outside legal counsel to perform legal services related to claims arising under policy coverages. For accounting purposes companies typically treat such expenses as "allocated loss adjustment expense" ("ALAE"). This means that these expenses are "charged against the file" rather than charged to "unallocated loss adjustment expense" ("ULAE").

24. Charles Petit testified for Respondent 20th Century that the expenses of 20th Century's in-house Legal

department were inappropriately classified as ULAE, which has the effect of raising 20th Century's ULAE (included in the efficiency standards) and reducing 20th Century's ALAE (not included in the efficiency standards), to its disadvantage compared to other companies who classify their legal expenses as ALAE. The Department initially made this classification because 20th Century reported the expense of its Legal department as ULAE on its Insurance Expense Exhibit to its annual report. Petit testified that because 20th Century's ULAE is thus raised, the company is subjected by the efficiency standards to a more stringent limit on its expenses than are companies that hire outside legal counsel who perform the same functions but whose costs are treated as ALAE. Petit testified that this was unfair, especially in light of the greater efficiency of using inside counsel.

ULAE to ALAE—Legal Department Expenses

25. In effect, Petit testified that with hindsight 20th Century's reporting to the Department of the costs of the company's in-house Legal department was inaccurate, although at the time the greater administrative effort required to classify such expenses as ALAE was not worthwhile. Petit testified that, had 20th Century in 1989 foreseen the current regulations and their differential treatement of ULAE and ALAE, it would allocate to individual claim files the costs of 20th Century's in-house Legal department's services that were rendered on an individual claim basis and could properly have been so allocated by the company. He testified that the lack of allocation of legal expenses to ALAE which could have been so allocated contributes to the Department's determination that 20th Century did not meet the efficiency standards.

26. Although he stated that because records were not kept by individual account in 1989, determinations of the exact amounts that could have been allocated to ALAE are difficult or impossible to make, Petit offered

an estimate that there were $8,153,211 in in-house legal costs in 1989, 90 percent of which were charged to ALAE but could have been allocated to individual claims files, and that the entire amount should be treated as ALAE for purposes of the Department's rollback calculation. He estimated initially that $1,400,460 in in-house investigative work by the Special Investigations Unit ("SIU") could have been allocated to ALAE in 1989. On rebuttal, he revised the latter estimate downward to $789,889, of which 90 percent had been allocated to ULAE.

27. Petit offered testimony and exhibits compiled from 20th Century's records indicating that a total of $462,962 was spent on outside counsel by 20th Century and 21st Century in the rollback year. He sponsored exhibits showing that 20th Century's in-house Legal department had costs of $8.3 million. He testified at the hearing that in his prefiled direct testimony he had subtracted from that total the amount that represented a proportionate allocation to the Legal department of total company indirect expenses. He testified that expenses such as depreciation of equipment and leasehold, telephone systems, insurance, and employee benefits were included in the costs of the Legal department, on the theory that those were costs that outside counsel would also incur and would pass on to an insurer in their billing rates. This produced a total of expenses for the in-house Legal department that Petit believes could have been allocated to ALAE of $8,153,211 for 1989, whereas only 10 percent of that amount was originally charged to ALAE and the rest to ULAE. Of the amount originally charged to ULAE, 91.88 percent was charged to the auto lines and the balance to the homeowners lines, in the amounts indicated on the bottom line of Exhibit Res-73.

28. Petit urged that the $8,153,211 in Legal department costs be removed from the ULAE number used by

the Department in its rollback calculation for 20th Century, and instead be classified as ALAE. He offered a proposed method for distributing that ALAE over the various lines of insurance for which rollbacks are required. Even though the Legal department worked almost exclusively on auto ligation under indemnity contracts, as established by the testimony of its head, John Bollington, Petit proposed to prorate the Legal department costs according to the total loss adjustment expenses for each line of insurance, assigning to each line 20th Century wrote in 1989 a percentage of the Legal department costs equal to the percentage of the total loss adjustment expense represented by each line. Petit also proposed alternatively that if the costs of the Legal department were instead allocated principally to auto lines, that they be allocated on the basis of the proportion of loss attributable to lines 19.2 and 21.1, Automobile Liability and Automobile Physical Damage respectively, as shown in Exhibit GY-3 to the testimony of George Yen.

29. John Bollington testified for Respondent that in 1989 he managed the Legal department of 20th Century, and that the approximately 42 attorneys employed in that department in 1989 represented 20th Century in litigation against 20th Century insureds in Los Angeles and Orange Counties, and that they performed virtually no other function for 20th Century. He testified that virtually all (approximately 98 percent) of the expenses incurred by 20th Century's Legal department in 1989 were litigation expenses and that, had these functions been performed by outside counsel, the costs could have been classified as ALAE.

30. Bollington testified that in the past, 20th Century considered tracking the Legal department's time and expenses by claim file, but rejected the idea. The Legal department instead has kept track of time by function (such as case load, settlements, and trials). Bollington also offered his opinion that going back at this time and attempting to reconstruct the time spent on individual

claim files by the Legal department in the rollback year would be virtually impossible. He testified, however, that 20th Century attorneys are able to compile their time spent on individual motions and the like when seeking sanctions from a court against opposing counsel. He also testified that all expenses incurred by his department are tracked on a claims file basis, even when paid on a bulk billing basis. He stated that files worked on by legal assistants in the Legal department are tracked by computer using certain code numbers, and that the computer could be programmed to make reports by claims file. Petit testified that there are no definite plans to change the method by which the Legal department tracks its time.

31. Bollington testified that the overwhelming majority of the work done by the Legal department is litigation, and that it is primarily related to auto litigation under indemnity contracts. He estimated in his prefiled direct testimony that approximately 90 percent of the work done by 20th Century's Legal department is auto litigation, in defense of its insureds, and estimated the figure at over 95 percent in testimony at the hearing. Bollington estimated that the amount of work done by the Legal department that is not insurance defense work is de minimis, less than 2 percent of total hours. The litigation work of outside counsel hired by 20th Century is not tracked, monitored or overseen by the Legal department, but by the individual departments within 20th Century, such as the Claims department, that hire the outside counsel.

32. In his prefiled direct testimony, Robert Hunter testified for the Department that he agreed in principle that litigation performed by in-house counsel could properly be classified as ALAE. However, he also testified that 20th Century should present sufficient evidence and supporting documentation to justify allocating a particular dollar amount to ALAE. Hunter testified from his expert knowledge that most large insurers have in-house counsel that perform many functions other than actual

litigation, and that the assertion that 98 percent of 20th Century's Legal department work was direct litigation and nothing else was very unusual in the industry; he would expect that a firm writing $600 million in insurance would have a large in-house Legal department performing many functions other than litigation.

33. At the hearing, Hunter testified that, after hearing the testimony of and reviewing the exhibits submitted by Petit and Bollington, he believed that 20th Century had adequately established that 98 percent of the hours spent by the Legal department should be reallocated to ALAE. Hunter gave his opinion that the dollar amount properly allocated to ALAE is 98 percent of the $8,153,211 figure for the costs of the Legal department given in Bollington's direct testimony. On redirect, Hunter recommended that the full $8,153,211 be reallocated. It is not entirely clear from the record whether Hunter intended to change his estimate of the costs of Legal that should be reallocated from his original 98 percent to 100 percent, but on the whole, acceptance of the 100 percent figure is justified. Hunter believed that the computer data retrieved by the company for the hearing provide a reliable basis for determining from where in ULAE to draw these costs for reallocation to ALAE. He also testified that the annual costs of the Legal department seemed reasonable compared to what he would expect outside counsel to charge.

34. On rebuttal, Petit suggested redistributing the various reallocated costs according to the way in which 20th Century actually distributed costs in its financial records in 1989. He sponsored Res-68, a business record made in 1989, showing how 20th Century distributed costs between ULAE and underwriting expenses for the Legal department, the SIU, and the Claims department. This exhibit showed that 90 percent of costs were assigned to ULAE for both the Legal department and the SIU, and 95 percent of costs were so assigned for Claims. The remainder of costs in each of these departments was

assigned to underwriting expenses. Hunter for the Department accepted this breakdown on costs.

ULAE to ALAE—Special Investigations Unit

35. Petit also testified that 20th Century maintains a Special Investigations Unit (SIU) that investigates suspected fraudulent claims. Petit testified that the SIU investigates only specific claims, and that its costs could have been allocated on a claim file basis in the rollback year had 20th Century foreseen the regulations' differential treatment of ULAE and ALAE. James Curley also testified that these costs could have been allocated by claims file in 1989, had the company wished to do so. Petit testified that precisely because records were not kept by individual account in 1989, determinations now of exact amounts that could have been allocated are difficult or impossible. However, Petit offered an estimate that $1,400,460 in in-house investigative work by the SIU could have been reported and categorized by 20th Century as ALAE in 1989 and should be so treated by the Department now.

36. At the hearing, Petit corrected the SIU cost figure in his prefiled direct testimony by subtracting out from it one half year's salary of a group of claims analysts who transferred out of the SIU during 1989 and the salary of one employee who was not performing SIU functions. These salaries, $131,518 in total, amounted to 19.34 percent of the salaries previously attributed to the SIU. Petit accordingly subtracted 19.34 percent, or $270,849, out of the SIU expense figure in his prefiled direct testimony. Petit testified that the remaining figure, $1,129,611, represents the costs of the SIU that he believes should be reallocated to ALAE. He testified that these costs should be reallocated to ALAE in the same manner as he originally suggested the costs of the Legal department should be allocated, i.e., prorated according to loss adjustment expenses per line of insurance. Wallace Voss, chief of the 20th Century Special Investigative Unit, testified that in

1989, the Special Investigative Unit performed no function other than investigating individual claims in order to detect fraudulent claims, and that this work could have been allocated by claim file at the time by 20th Century. He gave examples of the SIU's work, all of which related to auto insurance where the insured is typically the victim, i.e., Auto Liability insurance claims. He testified that none of the employees in the Unit worked on anything other than investigation of claim files referred to the Unit, with claims examiners managing settlements and field investigators performing the same type of investigative work as private investigators. Voss stated that SIU could have developed a billing system to track its costs and record personnel time on a claim-by-claim basis in 1989, but did not do so; he testified that to reconstruct each person's 1989 time now would be "extremely burdensome."

37. At the hearing, Voss testified that the SIU does the same type of work that is usually done by outside private investigators, and that this makes it different from the anti-fraud units in other insurance firms. He offered testimony and an exhibit indicating that the SIU is effective at discovering fraud and denying payment in fraudulent claims.

38. Voss testified that SIU personnel do not keep track of their time on a claims file basis, but that they do keep track of their expenses on a claims file basis. The SIU also hires outside legal counsel and outside private investigators; the costs of such outside investigators are charged on a per claim basis. On cross examination, Voss testified that some members of the SIU, including himself, do not do individual claims work. He also testified that costs of the SIU are still not tracked on a per claim basis, and no plans exist to do so. On redirect, Voss testified that the costs of SIU could be tracked on a per file basis, but that it would not be cost effective to do so. Petit confirmed that 20th Century has no plans to change the way the SIU tracks its personnel's time.

39. Hunter testified for the Department in his prefiled direct testimony that he agreed in principle that, insofar as 20th Century's Investigative Unit was performing claims investigations functions normally done on a contract basis, allocation of these costs to ALAE is appropriate. He testified that industry practice is to have investigative personnel that consist of claims examiners and field investigators whose costs are classified as ULAE, and that such standard costs as claims examiners and anti-fraud activities, important as they are, are properly classified as ULAE in to industry practice.

40. At the hearing, Hunter testified that, based upon the testimony of Petit and Voss, together with an examination of Res-15, his opinion is that 80.66 percent of the costs of the SIU should be reclassified from ULAE to ALAE. Hunter explained that Res-15 shows that 19.34 percent of the SIU costs were not actually special investigations, but similar to routine ULAE. Accordingly, Hunter believed that 80.66 percent, or $1,129,611, in SIU costs should be considered as ALAE. This is in accord with Petit's testimony at the hearing on December 19 correcting his prefiled testimony, as noted above. It adopts the larger of the two alternative measures that Petit had offered for the proposed amount to be reallocated from ULAE to ALAE, since it includes not merely the costs of the investigators only, but the costs of the full SIU (excluding certain items).

41. In his subsequent written rebuttal testimony, Petit revised the SIU figure for reallocation from ULAE to ALAE, reducing it slightly to eliminate salaries and associated overhead of personnel who did not perform SIU functions despite their assignment to that department. Res-67 shows $789,889 as the revised total for SIU that 20th Century now proposes should be reallocated. Hunter for the Department accepted an almost identical figure of $789,901. Applying Petit's testimony that 90 percent of the SIU costs had been classified by 20th Century as

ULAE in 1989, Hunter recommended that 90 percent of the SIU costs of $789,901, or $710,901, should be reclassified from ULAE to ALAE.

ULAE to ALAE—Bulk Billings

42. Petit testified that certain costs that were originally reported to the Department as ULAE in 1989, referred to as "bulk billings," also could have been assigned to individual claims files and would have been had the company foreseen the current regulations. He explained that such billings consist of various charges or invoices from various departments within 20th Century to individual vendors that are aggregated and paid in a lump sum to each vendor, although each invoice has a claim number on it and could have been charged to an individual claim file. Curley testified to the same effect. The bulk billings come from charges approved by three departments in 20th Century: 1) Legal; 2) the SIU; and 3) Claims. Petit testified that the bulk billings include such items as photocopying, medical records, medical examinations, and other outside services and vendors. Respondent's counsel stated that it would be impossible to verify that each and every bulk billing item from the rollback year had a claim number on the invoice, but that it was the policy of 20th Century to have such a number on the invoice of an item referred to bulk billing. Petit sponsored Res-18 listing all bulk billing items. Many of the items in this exhibit had been pulled from Petit's testimony and had been originally listed as costs of the Legal department or the SIU.

43. On redirect, Hunter testified that he could not recommend reallocation of any other bulk billings costs to ALAE unless 20th Century furnished further information as to the nature of these costs and the basis of their reallocation. A total of $1,261,524.19 is shown on Res-18 for the categories of "ALAE miscellaneous" and "ALAE other." Hunter testified that he could not understand these categories without more information.

44. Hunter testified at the hearing that, based on the testimony of Petit and the exhibits sponsored by Petit, he believed that the portion of bulk billings that should be recategorized from ULAE to ALAE consisted solely of that category that represents outside professional services. He offered as his opinion, based on the testimony of Petit and Res-18, that this portion of bulk billings was made up of billings for such outside professional services as attorneys hired outside of 20th Century by the Claims department for litigation and other professional legal services of the kind that industry practice normally classifies as ALAE. These expenses were grouped on Exhibit Res-18 on line number 82020, and amount to $573,827. At that point, he still needed more information about the expenses listed on lines 82050 and 82060 to determine whether they could properly be classified as ALAE. Hunter recommended that 20th Century be required to keep its future records in such a manner as to show clearly that allocated claims adjustments expenses were in fact so allocated, although he viewed the reconstruction of costs for 1989 performed by 20th Century for this proceeding as being reasonably well done and reasonably reliable.

45. On cross-examination, Petit testified that many of the bulk billing items that were billed through the Claims department were expenses that are routinely incurred by the Claims department of any insurer, and that he had no reason to believe that other property-casualty insurers typically allocated such expenses to ALAE. While Petit had testified that the functions of Legal and SIU were unique to 20th Century and not normally replicated by the legal or fraud units of most insurers, he admitted that the bulk billing items billed through the Claims department are routine and normal in nature, and could be tracked and charged to individual claims files by any other insurers; these costs are not unique to 20th Century. Petit admitted that allocating the $1.8 million of bulk billings billed through the Claims department might not be neces-

sary to put 20th Century on an equal footing with other insurers.

46. On rebuttal, Petit revised his opinion and stated that only the $1,261,875 in bulk billing costs reflected in account 82060 should be moved from ULAE to ALAE. To make all calculations consistent, Petit recommended the actual amounts transferred from ULAE to ALAE should be incurred expenses, rather than only paid expenses, and he sponsored Res-75 which reflects this adjustment by prorating the 1989 reserve changes on the basis of paid expense. Hunter for the Department accepted Petit's revised number for the Claims department's costs. He recommended that 95 percent of that amount be recategorized from ULAE to ALAE, based on Petit's testimony that 20th Century had classified 95 percent of those costs as ULAE as opposed to underwriting costs in 1989. This total was $1,198,781.

Reallocation of Former ULAE Expenses to ALAE by Line

47. Petit testified that 20th Century distributed ULAE to the major lines of business on the basis of a special study done by the company in 1989, with 90 percent of Legal costs being attributed to ULAE, 90 percent of SIU costs being attributed to ULAE, and 95 percent of Claims costs being attributed to ULAE. To redistribute ULAE to the "minor" lines of business within the "major" lines of automobile and property (i.e., Homeowners and Earthquake), Petit suggested a percentage allocation of the combined ULAE for Autmobile Liability (61 percent of all automobile ULAE) and Automobile Physical Damage (39 percent of all autmobile ULAE), and a percentage allocation of ULAE for Homeowners (97.57 percent of property) and Earthquake (2.43 percent of property). This percentage corresponds to the way in which 20th Century itself accounted for ULAE in 1989. On cross-examination, Petit admitted that while the distribution of costs for the "major" lines as either ULAE or underwriting costs was based on a special study, the distribution

of ULAE from "major" lines to "minor" lines was done differently, using salary in the case of automobile lines, and unpaid losses in the case of the property lines. Had the allocation between Auto Liability and Auto Physical Damage been based on the same method as that used to allocate expenses between Homeowners and Earthquake, i.e., losses, the split would have been over 90 percent to Auto Liability. Petit also testified on redirect that the portion of ULAE attributable to Autmobile Liability (69 percent of costs) was overstated by 20th Century in 1989, and the portion of ULAE attributed by 20th Century to Automobile Physical Damage (39 percent) was understated. In effect, he conceded that the 90 percent/10 percent split of expenses proposed by Department witnesses was more accurate. Based upon Petit's testimony, Hunter recommended that the following totals from various departments be reallocated from ULAE to ALAE as shown in CDI-166: 1) for the Legal department, 90 percent of $8,153,211, or $7,337,890; 2) for the Special Investigations Unit, 90 percent of $789,901, or $710,901; and 3) for Claims, 95 percent of $1,261,895, or $1,198,781.

48. Based on Petit's testimony as summarized above, Hunter recommended removal from ULAE from the major and minor lines according to the figures in CDI-163 and CDI-166, as the best representation of how 20th Century actually kept the records and accounted for these costs itself in the rollback year. He further recommended, based on Petit's testimony and Res-75, that the minor line ULAE figures be adjusted to convert them to incurred, rather than paid, amounts. The final figures are listed in CDI-163 and CDI-166.

49. The testimony of 20th Century's officials that its extensive use of in-house legal counsel, an in-house unit to investigate insurance fraud and bulk billings contributed to its efficiency was credible and there was no evidence to the contrary.

50. The Commissioner finds that the following amounts should be removed from ULAE for reallocation to ALAE: 1) for the Automobile Liability line, $5,716,759; 2) for the Automobile Physical Damage line, $3,470,965; 3) for the Homeowner's line, $785,110; and 4) for the Earthquake line, $18,805. These numbers reflect incurred costs. Respondent does not dispute these amounts.

51. Hunter recommended that the ULAE to be reallocated to ALAE should be reallocated to ALAE on the basis of the following division: 95 percent to Automobile Liability, and 5 percent to Homeowners. He testified that this is justified on the basis that ALAE is almost completely related to Auto Liability claims.

52. The Commissioner finds that the amounts to be removed from ULAE set forth in finding no. 50, above, should be reallocated to ALAE on the following basis: 95 percent to Automobile Liability, and 5 percent to Homeowners. The evidence best supports this allocation.

ULAE to ALAE—Future Record-Keeping

53. The Commissioner finds that, as a condition of availing itself of the reallocation of 1989 ULAE and ALAE provided here, Respondent shall adopt and implement a record-keeping system to allocate properly the costs it incurs in operation of its internal organizations engaged in claim defense and investigation typically classified as ALAE under prevailing industry practice, and to allocate properly its bulk billings. At a minimum, the record-keeping system shall:

a. capture the time of each employee in the relevant organizations no less frequently than weekly;

b. classify such time by line of insurance and as either claim-specific (i.e., allocable to ALAE) or non-claim-specific (i.e., allocable to ULAE);

c. provide for bulk billing records to be kept in such a manner that the Department can clearly deter-

mine that allocated claims adjustment expenses were in fact allocated and by what method; and

d. be described in a report to be filed with the Department's Rate Enforcement Bureau no later than September 30, 1992, and be placed in operation no later than January 1, 1993.

The Trimodal Structure of the Efficiency Standard

54. Petit testified in prefiled direct testimony that, in his opinion, the efficiency standards imposed by the regulations are unfair to 20th Century because they impose a far more rigorous standard of efficiency on direct writers of insurance than on those companies that employ independent or captive agents. Petit gave his opinion that such treatment penalizes 20th Century by imposing caps on its costs even when 20th Century's costs are below those of companies that use agents. However, Petit conceded on recross that the efficiency standard weights less efficient companies more heavily than more efficient ones. He also conceded that the calculation of the efficiency standard component of the rollback formula is driven by the disallowance of both excessive expenses and excessive profits. Petit also questioned the factual base underlying the standards, and the Department's decision not to introduce at this hearing the database or calculations used to set the efficiency standards. He urged that, given the stringency of the efficiency standards, the fullest consideration be given to the various adjustments to the Department's rollback calculations that 20th Century has proposed.

55. Petit acknowledged on cross-examination that, as a direct writer that does not employ agents, 20th Century has an inherent cost advantage over insurers who employ or utilize captive or independent agents, and that this cost advantage is widely recognized in the insurance industry.

56. On rebuttal, Petit offered an explanation for why 20th Century, despite being an efficient company, could fail the efficiency standard. He gave his opinion in a hypothetical purporting to show that because the regulations base allowable fixed expenses on total premium, and 20th Century's premiums were at the low end of the market, the same amount of fixed expenses will appear higher in relation to 20th Century's premium than to the higher premium of a less efficient company, even though the ratio of expense per policy is lower for 20th Century than for the hypothetical less efficient company.

57. On recross-examination, it was shown that the phenomenon to which Petit objected derived entirely from the fact that, in his hypothetical example, the insurer was subject to disallowances for reasons other than the efficiency standard—in that case due to profits in excess of the authorized rate of return. Adjusting the example to the authorized profit margin resulted in no expense disallowance.

58. The Commissioner finds that the trimodal efficiency standards have been determined in the regulations, and that those efficiency standards are binding in this proceeding. The Commissioner finds that the efficiency standards recognize and properly account for differences in the types of service different insurers provide, including whether they utilize agents that may be of use to the consumer but that necessarily result in an insurer incurring costs not incurred by a direct writer such as 20th Century. The Commissioner further finds that the efficiency standard does not unfairly prejudice 20th Century, and that no adjustment to the efficiency standard is required to put 20th Century on an equal footing with other insurers. Disallowance of excessive expenses and profits is required by the regulations and consistent with the intent of Proposition 103.

The Formula for Computing Allowable Fixed Expenses

59. Petit testified for Respondent that, in his opinion, the formula used by the Department for calculating fixed expenses for the rollback year is flawed in that it calculates fixed expenses as a function of actual loss experience for that year, which does not necessarily correspond to the fixed expenses that 20th Century actually incurred in 1989. He gave the example of a line of insurance that fortuitously suffered no losses as therefore being allowed no fixed expenses (despite the existence of at least some fixed expenses for each line) to demonstrate what Respondent believes is the irrational nature of the formula. Petit asked that 20th Century be allowed its actual fixed costs.

60. Hunter testified for the Department that the Department's methodology of calculating allowable expenses as a function of direct incurred loss is proper because it treats both overestimates and underestimates by a given insurer of its future losses on the same basis, allowing the company to recover for higher than expected losses but also lowering allowable expenses when losses were lower than expected. The use of actual incurred losses for a period now passed rather than hypothetical expected losses also avoids the inherent speculativeness of expected losses.

61. The Commissioner finds that the method of calculating allowable fixed expenses is not at issue in this proceeding, having already been determined in the regulations. On the basis of the evidence summarized above, the Commissioner also finds that Respondent has not demonstrated that altering the calculation of allowable fixed expenses to an expected loss basis and departing from the trimodal approach is necessary to remedy any unfair effect of the regulations on 20th Century. Elsewhere in this decision, we grant Respondent's request to combine the automobile lines for purposes of applying the efficiency standards. Respondent acknowledges that granting

such relief resolves its objections to the efficiency standards' trimodal nature and reliance on actual losses.

Combining of Related Lines for Efficiency Standard Calculations

62. Petit testified for Respondent that the regulations treat 20th Century unfairly in that they set efficiency standards for expenses on a line-by-line basis, rather than on the basis of a company's expenses taken as a whole (totalled for all lines). The effect of this on 20th Century, according to Petit, is that the total of 20th Century's expenses for all lines exceeds the Department's calculation of allowable expenses, taken as a whole, by only $2,153,244; however, when 20th Century's expenses are compared to regulatory efficiency standards on a line-by-line basis, 20th Century exceeds the efficiency standards by $7,524,652. It is the latter number that the Department initially used in its rollback calculation.

63. More specifically, Petit testified that 20th Century's Private Passenger Automobile Liability line had expenses in the rollback year that are $5,371,408 less than the efficiency standard for that line, but its Automobile Physical Damage line had expenses that exceeded the efficiency standard for that line by $6,745,591. Petit testified that these two lines of insurance are sold by 20th Century as a package, with at least 85 percent of 20th Century's customers buying both together. Petit gave his opinion that the expenses of the two lines should similarly be treated as a package, that is, that they should be totalled and compared on a combined basis to an efficiency standard that also totals the allowable expenses for the two lines.

64. Petit also testified that, since Inland Marine and Earthquake are only sold by 20th Century together with Homeowners insurance, that those three lines' expenses should be combined for purposes of determining whether allowable expenses meet the efficiency standard. Petit concluded that if such combination of expenses were

allowed, 20th Century would have a total disallowed expense of only $2,153,245.

65. Hunter testified for the Department that Petit's testimony suggested that 20th Century had not priced its Automobile Physical Damage and Automobile Liability lines correctly in 1989, and now wanted the buyers of one line to, in effect, cross subsidize the buyers of the other line. Hunter expressed his opinion that such mispricing is harmful to the insurance market because it impairs the ability of consumers to comparison shop. He disagreed with Petit's recommendation. However, on cross-examination, Hunter acknowledged that all consumers who purchased the "overpriced" Physical Damage line also purchased the even more "underpriced" Auto Liability line, so they were not hurt.

66. On rebuttal, Petit argued that 20th Century had charged both buyers of Automobile Liability only and buyers of the combined package of Automobile Liability and Automobile Physical Damage less than the Department's formula would have allowed it to charge, so that no customer was adversely affected by any "cross subsidy."

67. At the hearing, James Curley sponsored exhibits and offered testimony to show that 20th Century offers potential customers Automobile Liability and Physical Damage coverage without any distinction for purposes of marketing between those two lines of business, based on the same application. He also testified that since most customers insure more than one vehicle on the same policy, the overlap among customers of the two auto lines is 90 percent or more. Although he testified that Homeowners, Inland Marine and Earthquake are similarly offered together, the overlap among customers was much less than in the automobile lines (only 37 percent of Homeowners policyholders buy Earthquake and well under 10 percent buy Inland Marine). Also, Inland Marine coverage (at least beyond a certain amount) is sold based on a different insurance application.

68. The Commissioner finds that combining automobile lines is within his discretion under the regulations since the Department concedes that he has that authority because the issue has not previously been litigated. The testimony established that the line containing a mandatory coverage, Automobile Liability, was the low-priced line and did not subsidize the optional coverage for Physical Damage; that there was an almost complete overlap between customers purchasing both lines and those who only purchased one line purchased the "underpriced" line (Auto Liability); that the same personnel and departments at 20th Century were responsible for selling both auto lines, they were marketed together based on the same application, and drew on the same cost components of the company. The Commissioner finds further that while the Department's concern about the potential harmfulness of mispricing is very important in prospective ratemaking, that concern carries less weight in the rollback calculation.

69. The Commissioner finds that the Homeowners, Earthquake and Inland Marine lines should not be combined for purposes of the efficiency standard, since the evidence did not show the same unusual combination of factors that justifies combining the auto lines. The Commissioner also finds that 20th Century failed to make a convincing case for combining Other Liability. For example, Petit conceded that he did not know whether to argue for combining it with the auotmobile or homeowners lines and, in any case, its counsel conceded that the disallowance in this line of only $6,374 was not significant to 20th Century.

Computation of Rollback on Direct Basis Rather than Net Of Reinsurance Premiums and Losses Ceded

70. The regulations provide that the rollback liability shall be calculated on a direct, rather than net, basis. (§ 2645.9.) Direct ratemaking recognizes premiums collected from policyholders and losses paid on policies with-

out taking into account any reinsurance transactions. Net ratemaking adjusts direct premium by deducting premium amounts ceded to reinsurers and adding reinsurance commission ceded; done properly, it also adjusts losses by deducting reinsured losses. Twentieth Century contended that by basing the calculations on direct premium, the Department unfairly and unconstitutionally failed to take into account premium that it had ceded during the rollback period to reinsurers, primarily in its Earthquake line, and to a lesser extent in its Homeowners, Inland Marine and Other Liability lines.

71. Petit testified that 20th Century had ceded net earned premium on the Earthquake line (adjusted for ceded commissions) of $4,465,412, as well as smaller amounts in the other lines, totalling $5,605,325 in net ceded premium, and urged that this net sum be treated as an allowable cost for purposes of the rollback calculation. ~~Since~~ 20th Century experienced no loss in the Earthquake line during the rollback year, it received no reinsurance payments from the companies with whom it reinsured, whereas many other insurers who did have such losses received such payments. Petit testified that 20th Century is obligated under the rollback formula to make a refund of premium in the Earthquake line for 1989 based on the entire direct premium it received for that line, and is not allowed to deduct the premium ceded by 20th Century to other insurers for reinsurance, with the result that the rollback calculation premium for its Earthquake line includes premium that it did not retain. Petit testified that this situation is unfair. Petit acknowledged that even if 20th Century had known exactly how the rollback regulations would treat its reinsurance in the Earthquake line, which accounted for about 80 percent of its total reinsurance, it would still have purchased such insurance. Curley testified that 20th Century prudently calculated the amount of reinsurance it needed to buy on its Earthquake line. He also testified that 20th Century is particularly affected by this issue because it writes

only in California and is a major writer of Earthquake insurance, and its customers take such coverage about twice as often as the industry average. Finally, he testified that the $933,020 allowable premium calculated by the Department's formula for the Earthquake line was inadequate to cover 20th Century's exposure in this line in 1989.

72. Hunter testified for the Department that Petit's proposed treatment of ceded premium for the Earthquake line on a "net" basis is inapropriate, since the regulations account for all premiums and expenses on a direct, not net basis, with no exceptions for individual lines. To treat any lines on a net of ceded premium basis would not take account of the amount received from reinsurers to cover claims they have reinsured. Hunter gave his opinion that since reinsurance rates are not regulated, counting only the "net" reinsurance premium would create a regulatory hole through which certain charges might escape regulation. His opinion was that the Department's treatment of reinsurance costs using direct premium and direct losses is fair, proper under the regulations, and should be applied consistently to all insurers.

73. Petit testified on rebuttal that Hunter's objections to allowing 20th Century's reinsurance costs to be allowed in the rollback formula could be answered by performing all calculations on a net, rather than a direct basis, so that both losses and premium were calculated on net basis. He testified that 20th Century had $868,835 in recoveries from reinsurers ("ceded incurred losses"). Petit disputed Hunter's concept of a "regulatory hole" through which unregulated reinsurance payments could fall, stating that this concept is applicable only to prospective rate approval, not to retrospective rollback calculations.

74. Petit agreed on cross-examination that the regulations should treat all insurers alike as to the issue of computing rollback liability on either a direct or net basis. Petit admitted that only insurers which reinsured in 1989

and suffered little or no losses are disadvantaged by direct ratemaking. 20th Century was the only insurer that Petit knew of which writes a significant amount of Earthquake insurance, reinsures, and has little or no Northern California exposure (and thus did not experience loss due to the 1989 Loma Prieta earthquake). Petit also admitted on cross-examination that under 20th Century's proposed calculation of rollback obligations on the basis of net rather than direct premium, a company that had sizeable Northern California exposure, reinsured its total premium, and then suffered losses in an earthquake, would recover its full premium from reinsurers yet have no rollback obligation because it had no net premium.

75. The Commissioner finds that calculating rollback liability on a direct basis is consistent with and required by the regulations governing rollback calculations, that use of direct premiums and losses for all insurers is both proper and fair, and that fairness forbids the calculation of the rollbacks of some insurers on a net basis and others on a direct basis. Inconsistent treatment of insurers in the matter of direct versus net premium so that rollbacks were calculated for each insurer based on the minimization of that insurer's rollback would result in different methods being used for different insurers (perhaps even calculations of one line on a net basis and one on a direct basis for the same insurer) to the detriment of both consumers and competing insurers. We see no reason to allow such inconsistent treatment, especially since even 20th Century's witness conceded that all insurers should be treated alike. As Hunter testified and Petit acknowledged, most insurers benefit from use of the direct basis since they had large losses ceded to reinsurers in 1989 due to the Loma Prieta earthquake in Northern California, and those recoveries from reinsurers are not recognized on a direct basis. Therefore, the uniform use of direct rather than net ratemaking was more favorable to the industry as a whole, while placing the higher rollback obligation on

those with low losses and thus better able to pay it. The Commissioner also finds that Respondent's prudency argument is directed at considerations appropriate in prior approval ratemaking, but not in calculation of the rollback.

Respondent's Proposed Additions to Other Income

76. Petit testified for Respondent that the Department has not adequately counted losses suffered by 20th Century in the "other income" category, losses consisting of uncollected premiums and losses on the sale of fixed asset equipment. He gave his opinion that such losses should be accounted for in the "other income" category, producing a negative number of ($264,614) in that entry instead of the current positive $231,853.

77. At the hearing, Petit sponsored exhibits that gave a detailed listing of uncollected premiums and a detailed listing of losses on the sale of fixed asset equipment such as computers. Petit indicated that his prefiled testimony had included the charged-off premium for only 20th Century and not 21st Century, and that the total of the two companies was $385,427 (for 20th Century) plus $11,988 (for 21st Century), for a total of $397,415. On redirect, Petit offered testimony and sponsored an exhibit documenting a particular loss in the "other income" category, and satisfactorily explaining how an outmoded IBM computer was donated and written off.

78. Hunter testified for the Department that he believed 20th Century had properly documented the charged-off premium and the losses on sales of equipment presented by Petit, and he recommended that those numbers be accepted by the Department.

79. On the basis of the testimony summarized above, which is in substantial agreement, the Commissioner finds that the sum of $397,415 should be deducted from Respondent's "other income" category and that the resulting

changes should be made in the Department's calculation of Respondent's rollback liability.

Respondent's Proposed Corrections to the Insurance Expense Exhibit

80. Petit testified for Respondent that the 1989 Insurance Expense Exhibit (IEE) submitted by 20th Century contained several errors, which were then used by the Department in performing its rollback calculation, and that the Department's calculation is correspondingly in error. Res-19 is a copy of the IEE containing the errors in question; the errors are found on page 2, line 5 of that exhibit. The errors concerned direct commissions and brokerage fees for the Homeowners, Inland Marine, and Earthquake lines of business. Petit stated that the numbers for those three lines contained in line 5, page 2 of Res-19 should be added together, and the total inserted in column 17 (Other Liabilities) at line 5, instead of the erroneous number (zero) in the IEE submitted to the Department.

81. Hunter testified for the Department that, while errors should be corrected, sufficient supporting information must be provided to prove that the numbers involved were, in fact, errors. Further, 20th Century should demonstrate that *all* errors have been found and corrected, not merely errors that are favorable to the company, to avoid regulatory adverse selection.

82. Petit testified at the hearing that he first suspected that an error had occurred during the course of this proceeding, and that he had determined from discussing the matter with 20th Century's accounting director that the error had been made in 1989 through inadvertence. The error was discovered in 1990 but was not corrected at that time because it was considered insignificant. Res-20 is a copy of a worksheet created by the accounting director in 1990 when he discovered the error. Petit

further testified that 20th Century's initial error on the IEE caused the Department to use an erroneous number in performing its rollback calculation. Respondent's counsel indicated that the change should be made only to 20th Century's IEE, and no change was needed to 21st Century's IEE.

83. Hunter then recommended making the correction to the IEE and the corresponding change in the rollback calculation.

84. On the basis of the evidence summarized above that the error was made and discovered in good faith, the Commissioner finds that the changes in Res-21 should be made to the Department's calculation of 20th Century's fixed expenses and to the rollback calculation.

Respondent's Objections to the Leverage Standards

85. Petit initially testified for Respondent that the Department's treatment of leverage in its rollback calculation is inconsistent in that the Department is ordering 20th Century to pay a rollback which must come from surplus at a time when the Department is also questioning, for prior approval purposes, whether 21st Century has sufficient surplus. Petit cited a letter from the Department to 21st Century asking to be advised when 21st Century has acquired sufficient surplus to have a 3 to 1 net premium to surplus ratio. Petit urged that instead of using Respondent's actual leverage, the Department should impute to 20th Century a lower leverage factor (i.e., higher ratio of surplus to premiums).

86. At the hearing, Petit admitted that the Department has not asked *20th Century* to lower its leverage, and that *21st Century* was able to meet all of the Department's leverage requirements without impairing the aggregate leverage of the two companies. The record also shows that the letter attached to Petit's direct testimony was written in April 1991 and merely asked to be in-

formed when 21st Century had the required capital without making any demands. The record also shows that this letter was written in response to a 1987 letter from 21st Century's then-Senior Vice-President and Chief Actuary James Curley acknowledging 21st Century's shortage of surplus and also acknowledging that 20th Century, which Curley projected would earn approximately $60 million in investment income in 1988, was available as a source of increased capital to 21st Century.

87. Hunter testified for the Department that Petit's suggestion that a lower imputed leverage factor be used was wholly without merit, in that it would in effect allow 20th Century to make a profit on surplus that it did not in fact have in 1989.

88. The Commissioner finds that the use of actual versus imputed leverage in rollback calculations is not at issue in this hearing, having already been determined in the regulations. Moreover, on the basis of the evidence summarized above, the Commissioner also finds that Respondent has not demonstrated that any change is needed to remedy any unfairness to 20th Century, or to place 20th Century on an equal footing with other insurers subject to the rollback regulations. Rather, the evidence establishes that granting Respondent's request would allow 20th Century to earn a return at policyholders' expense on surplus that it did not in fact possess during the rollback year.

The Computation of Premium Taxes on an Earned Premium Basis

89. Petit testified for Respondent that the Department's treatment of the gross premium tax does not allow 20th Century to claim as expenses the full amount of premium tax it actually paid. He testified that this occurs because the tax is actually paid on total written premium, whereas the regulations only allow as expenses the amount of premium tax that would be due on earned premium;

for a rapidly growing company such as 20th Century, written premium will exceed earned premium. Petit expressed his opinion that the regulations unfairly disallow actual premium taxes paid by 20th Century because of this phenomenon, and urged that the company be allowed to use its actual premium tax payments in the rollback formula.

90. At the hearing, Petit also testified that 20th Century paid premium tax for 1989 on the full amount of its written premium, but that the rollback forces it to return premium to policyholders without a corresponding return to it of the premium tax it paid for 1989.

91. On cross-examination, Petit admitted that he has not inquired of state tax officials whether they would honor the filing of a corrected tax statement either for 1989 or for the year in which the rollback is paid, and that he has not sought the advice of tax counsel as to whether such a filing is permitted.

92. Hunter testified for the Department that the regulations essentially treat an insurer's income and expenses (including premium taxes), on an earned/incurred basis, rather than on a written/paid basis. He offered his opinion that mixing the two approaches by computing premium taxes on an as-paid basis while computing all other components of the rollback percentage on an earned/incurred basis is inappropriate.

93. The Commissioner finds that the proper method for calculating premium taxes is not at issue in this hearing, having already been determined in the regulations. Moreover, the Commissioner finds that 20th Century has not demonstrated that the relief sought is required to remedy any unfairness to 20th Century. Further, the Commissioner finds that 20th Century has not proved that it has or will suffer any injury, since it has not explored the potential remedy of an adjustment of its tax liability by the state tax authorities.

Implementation of the Rollback Obligation as a Percentage of Written Premium

94. Petit testified for Respondent that implementation of the rollback formula unfairly penalizes 20th Century in that the rollback percentage is calculated using earned premium as a base, but the rollback amount applies the rollback percentage to written premium, which in the case of a growing company like 20th Century is greater than earned premium. Petit stated that the actual rollback amount should be adjusted to reflect the discrepancy between 20th Century's written and earned premium.

95. Hunter testified for the Department that while the regulations initially determine the rollback percentage based on earned premiums, this percentage must be applied to written premiums because Proposition 103 requires that the ultimate rollback amount be a percentage of premium paid on policies in the rollback year.

96. The Commissioner finds that the application of the rollback percentage to written premium is not at issue in this proceeding, having already been determined in the regulations. Moreover, Proposition 103 requires that the reduction be based on written premiums.

Disallowance of Expenses for Bad Faith Judgments and Associated Loss Adjustment Expenses

97. Petit testified for Respondent that the Department has disallowed certain expenses relating to "bad faith" or extra-contractual liability cases. He testified that only two cases are at issue, the *James* case and the *Algee* case. The judgment in the *James* case was rendered in 1990 and was appealed. The appeal is still pending and therefore, in Petit's view, is not yet a "judgment" for purposes of the rollback calculation since it might be revised. In the *Algee* case, a judgment was rendered in 1989 for compensatory damages, with the trial judge ordering a new trial on punitive damages. That judgment was ap-

pealed, affirmed in 1991, and remanded for a new trial on punitive damages which has not yet taken place. In Petit's view, the fact that the punitive damages claim was still pending meant that there was also no "judgment," even though the compensatory damages claim has been finally determined and in fact paid to the plaintiffs. Petit testified that because 20th Century did not establish a reserve for this case in the rollback year, only the $106,564 in costs actually paid by 20th Century in 1989 should be subject to the rollback calculation. He testified that it is 20th Century's policy not to create a reserve for bad faith liability. Instead, it captures the costs in its financial data only when amounts are actually paid.

98. In accordance with the agreement of the parties and with the permission of the ALJ, Petit submitted a declaration dated March 6, 1992 and admitted into evidence on March 17, in which he listed the costs associated with the *Algee* case in all years from 1987 to 1992. These costs included $50,000 in compensatory damages, $3,545 in costs, $12,572 in interest, and ALAE of $179,855.03 to date. This totals $245,972.03 for the *Algee* case.

99. Hunter testified for the Department that in his experience, it is not industry practice to create a reserve for bad faith judgments. He testified that if such a reserve is created, it is never labelled as being for bad faith judgments, and without such a label, any such reserve would be very difficult to identify. He offered his opinion that capturing costs in the year the trial judgment is handed down is a practical way to handle the issue, since a judgment is an objective occurrence that is easily verifiable in a particular year and costs associated with it can be captured readily at that point, minimizing the administrative burden on insurers and the Department. He recommended accounting for all costs associated with a bad faith judgment (or the bad faith portion of a judgment), at least up to that point in time, in the year that

the judgment occurs. Using this approach, Hunter recommended disallowance of ALAE associated with the *Algee* bad faith trial judgment in 1989 incurred prior to and during 1989, but did not expressly address treatment of ALAE in *Algee* after 1989. Hunter testified that if a trial court judgment is later reversed on appeal, a credit can be issued in the year of the reversal. However, on cross-examination Hunter conceded that if a company did not seek a rate increase in the year that a bad faith judgment whose costs had previously been excluded was reversed, it would not recover those disallowances. Nor did he address the precise method to be employed that would ensure that credits would fully offset prior disallowances in the event of a reversal, such as the question raised by Respondent about the potential effect if trending were to be applied to bad faith disallowances (although such a method could be devised). Hunter accepted Petit's figures relating to the *Algee* and *James* cases.

100. The Commissioner determines that, for purposes of the rollback calculation, bad faith "judgment" means a finally determined bad faith claim from which all appeals have been exhausted as to that particular claim or award, regardless of whether some other claim brought in the same lawsuit is still pending. This minimizes the need to revisit disallowances of judgments subsequently revised, while still ensuring that expenses associated with clearly established bad faith are not passed on to consumers. Therefore, the compensatory damage award in *Algee* in 1989, which has been affirmed on appeal, is a judgment for purposes of the rollback regulations, even though the claim for punitive damages is pending for retrial. However, where appeals are still pending on every portion of the bad faith trial judgment (or bad faith portion of a trial judgment), as in *James,* no disallowance is appropriate. The Commissioner further determines that all ALAE incurred in 1989 associated with a bad faith judgment (in the sense set forth here) should be disallowed in the rollback calculation.

101. The amount of $172,681 for damages and ALAE associated with *Algee* incurred in 1989 is properly disallowed from Respondent's recoverable expenses, as reflected in ALJ-20 (Exhibit 4.A.2 thereto).

STATUTORY AND CONSTITUTIONAL ISSUES

The Commissioner's Authority to Consider Respondent's Challenge To Its Rollback Determination as Unconstitutional "As Applied" and Contrary to Proposition 103

102. The Commissioner finds as a matter of law that he has the authority to interpret existing law in the course of discharging his duties and to consider evidence offered before him in light of constitutional standards, and does so here since the parties have urged him to do so and did not object to the introduction of Respondent's evidence directed toward its constitutional and statutory challenges.

The Standard for Determining Rollback Rates Under Proposition 103 as Modified by Calfarm

103. Respondent argues that price regulation by rate of return is appropriate only in monopolistic industries, and that "price-capping," i.e, a price ceiling model of regulation, is applicable to competitive industries such as insurance.

104. Under Proposition 103, 20th Century, like all other property-casualty insurers, is obligated to roll its rates back 20 percent, barring a constitutional impediment. *Calfarm, supra,* 48 Cal.3d 805, 258 Cal.Rptr. 161, found such a potential impediment in the possibility that a 20 percent rate reduction would drive a particular insurer's rate of return below the constitutional minimum.

105. *Calfarm* characterized the applicable constitutional standard, taken from *Hope,* 320 U.S. 591, as depending on the company earning "a fair rate of return." The *Calfarm* court repeatedly described the potential constitutional infirmity of Proposition 103 as the possibility that some insurers might not earn the required "rate of return." (*See* 48 Cal.3d at 818-19.)

106. The Commissioner finds as a matter of law that Proposition 103 requires the application of rate of return regulation to 20th Century and all other property-casualty insurers to determine the rollback rate that is not confiscatory.

107. Insurance Code section 1861.01, subdivision (a), provides:

> "For any coverage for a policy for automobile and any other form of insurance subject to this chapter issued or renewed on or after November 8, 1988, every insurer shall reduce its charges to levels which are at least 20% less than the charges for the same coverage which were in effect on November 8, 1987."

This subdivision was upheld by the Court in *Calfarm*.

> "[W]e have concluded that the standards set by section 1861.01, subdivision (a), govern rate regulation during the first year of the initiative's operation." (*Id.* at p. 823.)

108. As enacted by the voters, section 1861.01, subdivision (b), declared that the 20 percent rollback contained in subdivision (a) was subject only to the right of an insurer to seek relief if "substantially threatened with insolvency." In *Calfarm*, the Supreme Court struck that standard and held that the "inadequacy" standard of section 1861.05 was synonymous with "confiscatory" and thus functioned as an alternative standard to the invalid one, ensuring that the rollback rate would be adjusted upward if necessary to ensure a constitutional rate of return:

> "Since a confiscatory rate is necessarily an 'inadequate' rate under the statutory language, section 1861.05 requires rates within that range which can be described as fair and reasonable and prohibits approval or maintenance of confiscatory rates." (*Id.*, at 822-23.)

109. The Commissioner finds as a matter of law that the relevance and function of section 1861.05 for the rollback year was that it incorporated, in the inadequacy standard, the constitutional prohibition on confiscation, and thus ensures that rates will not be constitutionally inadequate.

110. The Commissioner finds as a matter of law that the rollback rate percentage need not be set at a level that fulfills whatever hypothetical expectations were held during the rollback year by investors in 20th Century stock (which cannot, in any case, accurately be determined), and that the minimum nonconfiscatory level need not be set at a rate of return that might theoretically have been needed to attract capital in that year (a year in which no capital was raised through the stock market in any case). In addition, the Commissioner finds that the fact that the rollback is a nonrecurring event that is based upon past, known events is a factor that may be considered in determining what is a confiscatory level.

111. The Commissioner finds as a matter of law that, insofar as the interests of consumers and insurers conflict, the Commissioner is obligated to carry out the consumer-oriented commands of Proposition 103, so long as the constitutional limits on confiscation are observed.

112. The Commissioner finds as a matter of law that no legal requirement mandates that each insurer, or any insurer, be vouchsafed a rate of return that matches its individual cost of capital during the rollback year.

Applying the Standard of Confiscation to 20th Century

113. The Commissioner finds that the authorized rate of return for insurers in the rollback year has already been determined in the RCD-2 proceeding, and that Respondent is entitled to a variance from that rate of return only if it demonstrates that it meets the regulatory grounds for such a variance or if it demonstrates a constitutional right to the grant of such a variance.

114. The Commissioner finds as a matter of law that the rollback percentage established in the proceeding for Respondent will not be confiscatory so long as it allows a rate of return within the range of fair and reasonable rates and so long as 20th Century continues to be able to operate successfully, albeit perhaps not according to its own very ambitious growth plans. The Commissioner finds as a matter of law that 20th Century is not entitled to a rate of return that allows it to grow at any rate that it wishes or has planned.

115. Respondent's low prices compared to other insurers in California reflect in part its lower costs as a direct writer compared to insurers who provide services through agents. 20th Century's rates also reflect in part its selectivity in the drivers it would insure, coupled with very high retention rates of its customers.

116. Respondent offered calculations of the Herfindal-Hershman Index (HHI) for the insurance industry in support of its claim that California's property-casualty insurance industry is highly competitive. However, Respondent's witnesses did not adequately define the relevant geographic market that should be used in the HHI analysis. The Department introduced alternative calculations of the HHI's which excluded firms that did little or no business in Northern California and treated the Northern and Southern California Automobile Clubs as merged since they generally do not compete with each other. The Department's estimates of HHI's were in the range considered by the United States Department of Justice to raise competitive concerns. They illustrated the importance of carefully defining the market and cast doubt on the evidentiary value of Respondent's HHI calculations.

117. The Commissioner finds that Respondent has not proven the existence of a strongly competitive market for insurance in California, particularly in the rollback year, in view of the limitations of its HHI analysis, the fact that insurers still enjoy federal antitrust immunity, the fact that

until Proposition 103 also had a state antitrust exemption for property-casualty ratemaking activities, and the difficulty of consumer comparison shopping.

118. James Curley testified for Respondent that the rollback calculated by the Department would reduce 20th Century's surplus and increase its leverage ratio. Curley gave his opinion that such an increase in leverage would slow the company's growth and its ability to offer low-priced insurance to California consumers. However, on cross-examination, Curley admitted that 20th Century was able to lower its leverage ratio in 1986 by raising additional capital, and in 1987, 1988, and 1989 by retaining earnings. He also acknowledged that 20th Century paid dividends to shareholders out of surplus in 1988, 1989, and 1990.

119. The Commissioner finds that the rollback ordered in this decision will have little or no effect on 20th Century's ability to grow. The evidence in this proceeding establishes that 20th Century has been able to expand rapidly largely through the use of retained earnings, that it has been able to acquire new capital to reduce its leverage when needed, and that it has paid dividends. It further establishes that to the extent that 20th Century has already set aside reserves against its rollback liability, a corresponding reduction in surplus has already occurred. Nonetheless, 20th Century has continued to grow by more than 10 percent each year from 1989 through 1991.

Cost of Capital

120. Respondent's witness Stiglitz testified in his direct testimony that 20th Century is entitled to a rate of return between 74 and 99 percent including a 2.08 multiplier. He later abandoned the multiplier. At trial, he offered several different proposed rates of return, ranging from 20 percent to 28 percent, to 41 and one-half percent, and finally 33 percent, although he testified that he could not with certainty recommend a single number.

121. Stiglitz' figures concerning Respondent's required rate of return were derived from his use of three theoretical models: the dividend-yield or discounted cash flow (DCF) model, the capital asset pricing model (CAPM), and an event study. The Commissioner finds that none of these models produced substantial evidence to support any of the figures to which the witness testified.

122. Stiglitz' testimony on the issue of Respondent's required rate of return suffered from inconsistencies, unsubstantiated and self-serving assumptions which drove his conclusions, and implausible extreme positions. The witness' credibility was further undermined by his failure on cross-examination to answer questions capable of a yes or no answer with a straightforward response, engaging instead in nonresponsive disgressions.

123. The Commissioner finds that, while Respondent has the burden of proof in this proceeding, it has not carried its burden of establishing that its specific situation entitles it as a matter of constitutional mandate to a deviation from the 10 percent rate of return established in the regulations.

The Dividend Yield Model

124. The dividend yield/DCF model seeks to calculate the present value of a future stream of dividends expected from the company. The result consists of two components: the current dividend yield (an objective fact derived by dividing the current dividend rate by the market price) plus an expected growth rate (the projection of a selected growth rate into the infinite future).

125. Applying this technique, Stiglitz produced a cost of capital for Respondent of 26.1 percent, based on a current dividend yield of 1.95 percent and expected growth rate of 24.1 percent. Over 90 percent of this result was due to the growth rate selected by the witness.

126. Stiglitz derived his expected growth rate by taking 20th Century's average growth rate for 1986 through 1991. This period was one of extraordinary growth for 20th Century, during which it grew from a small firm to occupy a significant position in the California insurance market.

127. The Commissioner finds that Respondent's witness used the dividend yield/DCF model improperly by taking an extraordinary period of growth and projecting that growth rate into perpetuity.

The Risk Premium Model

128. Stiglitz also presented a "risk premium" or CAPM analysis. This analysis involved taking the rate of return authorized for public utilities by the Public Utilities Commission ("PUC") in 1989 and adding an additional amount based on his opinion that the insurance industry had a higher risk. The latter was derived from a "beta analysis" which theoretically measures the volatility of a given security (which is equated with risk) compared to the volatility of the whole market. Applying these techniques, the witness added 7.009 percent to the 13.0 percent rate of return for utilities in 1989, yielding a 20 percent rate of return for 20th Century.

129. The Commissioner finds this analysis to be unpersuasive. The 13.0 percent rate of return authorized by the PUC is an inappropriate starting point to establish an insurer's rate of return. That figure represents the PUC's view of the appropriate point in the range of reasonable returns at which to set rates in that year. It does not purport to define the lower end of the range of reasonable returns and, therefore, cannot be used to determine the minimum nonconfiscatory rate.

130. The Commissioner has previously found that deriving an insurer's rate of return by adding to utility returns is an invalid method. (*See RCD-2 Decision* at 17.)

The Department pointed out that where utilities invest their capital in depreciating plant and equipment, insurers invest their capital in appreciating securities. Consequently, investors in insurance companies can expect a larger percentage of their returns to come from appreciation, which may not appear on the companies' income statements. Respondent's witness failed to take this difference into account in his analysis.

131. The Department also pointed out that in establishing the applicable rate of return for insurers in the RCD-2 proceedings, the Commissioner took into account the fact that the ratemaking formula did not capture unrealized capital gains by making a downward adjustment of 2.64 percent. Respondent's witness failed to address this aspect of the regulations.

132. Stiglitz also testified that the 20 percent rate of return should be increased by 3.4 percent to 23.4 percent on the grounds that 20th Century is a "small firm" with added risk. However, the witness did not know the definition of "small firm" and revised his "small firm" adjustment downward, admitting that it could be as low as 1 percent.

133. A day later, Stiglitz testified to an 8 percent "small firm" adjustment based on his further analysis. However, this analysis, too, was flawed in that it was derived from an analysis of stocks on the New York Stock Exchange (NYSE) which expressly cautioned that "one should not assume that findings that hold for NYSE firms will hold for firms elsewhere." 20th Century's stock was not listed on the NYSE during the relevant period.

134. In addition, Stiglitz' "small firm" adjustment is unpersuasive in that it creates the risk of double-counting since the individual beta for 20th Century already should have captured the firm's riskiness (regardless of its source) compared to the market in general. The witness did not provide a satisfactory explanation of why any of the

"small firm" adjustments that he proposed were not duplicative of the enhancement that he had made already as part of his beta analysis. By Stiglitz' own admission, he did not study the relationship between small firms' betas and those of other firms, nor was he aware of any studies relating the magnitude of the "small firm" effect to the value of the beta.

135. Stiglitz initially recommended a tentative additional 5 percent upward adjustment in Respondent's rate of return based on his view that the rollback constituted "retroactive" regulation. For the reasons set forth elsewhere in this decision, the witness is mistaken. In addition, the witness's testimony on this point is highly speculative and unsupported by precedent.

136. Stiglitz also initially recommended an additional upward adjustment in Respondent's rate of return to compensate the company for retaining earnings rather than paying them out as dividends to shareholders. On cross, the witness admitted that there is a body of economic theory authored by Nobel Prize recipients Modigliani and Miller which is contrary to his position. Also, Stiglitz' recommendation conflicts with his own admission that most investors view dividends as tax disfavored, and is without legal support.

The Event Studies

137. Stiglitz presented an "event study" purporting to estimate the stock market's reaction to the firm's stock offering on May 13, 1986. The witness theorized that the offering diluted the value of the old owners' shares by 24.22 percent (or $121 million), requiring an extra high return to compensate them for the dilution beyond the 20 to 30 percent or more than he had already advocated.

138. The event study was shown to be extremely susceptible to manipulation simply by the choice of the starting and finishing dates for the base period. Stiglitz' study

was based on a base period of 30 trading days from March 19 to April 30, during which he compared the daily changes in 20th Century's stock to daily changes in the NASDAQ insurer index. At the time that he originally sponsored the testimony, he could not explain why that particular period was chosen, nor attest to its correctness.

139. Whereas selection of the 30-day base period yielded the 24.22 percent decrease in value testified to by the witness, use of a 31-day period produced an increase in the company's value of 3 percent and a 29-day period produced a decrease in the company's value of over half. These dramatically different results were obtained simply by changing the base period by a single day and show the inherent unreliability of such studies.

140. Over a twelve-day delay in the hearing, Stiglitz prepared a second event study which purported to show that the 1986 stock issuance reduced 20th Century's value by $100 million (or, more conservatively, $80 million), plus or minus $60 million. Despite extensive modifications to the original study, the witness' new event study remained susceptible to extreme and implausible variations from a mere one-day variation in the base period. These variations demonstrate once again the unreliability of this methodology.

141. Stiglitz conceded that his examination was constrained by his own "predisposition" of what and when the market response to stock sale would be. This predisposition influenced the witness to attribute downward movements in 20th Century's stock price to the stock issuance while dismissing the upward movement in the stock price immediately after the stock issuance as mere "noise."

142. This predisposition also led the witness to ignore or dismiss other possible explanations for downward movements in 20th Century's stock price. For example, in preparing his event studies Stiglitz failed to consider the pos-

sible effects of a April 8, 1986 public announcement that the president and founder of the company and four other insiders were planning to sell several thousand shares of 20th Century stock and contemporaneous public statements by a prominent candidate for Governor announcing his intention to regulate insurers severely if he were elected.

143. Even if Respondent's witness had conducted the event studies in an objective manner, the use of these studies to support an extra high rate of return is fundamentally flawed. A high rate of return would extend to all 20th Century stockholders regardless of whether they held shares before the 1986 offering or purchased stock during or after the offering. Yet under Stiglitz' theory, only the original owners prior to the offering should get the higher returns for "dilution" of their original holdings. Moreover, the studies attempt to prove Respondent's cost of capital in 1989 on the basis of a 1986 event. Such studies are of little persuasive value, especially in light of other evidence which shows that there have been significant changes over this period.

144. The Commissioner finds that Respondent has failed to prove the validity of the event studies as an analytical tool to prove 20th Century's cost of capital. The Commissioner further finds that Respondent has not proved that the 1986 stock offering produced a dilution effect persisting into the rollback year that requires a variance to the rate of return provided for in the regulation.

145. The Commissioner finds that economic testimony of the kind tendered by Respondent is inherently speculative and of little value in determining an insurer's past cost of capital.

Use of Actual Rather Than Expected Losses

146. Respondent argues that the regulations improperly take into account only actual losses, rather than ex-

pected losses, particularly in low frequency, high severity lines where the two can differ significantly in a given year.

147. The Commissioner finds that the regulations employ a rational system for recognizing losses, in conformity with legal requirements and industry practice, reasonably adapted to the requirements of assessing rollback year rates. The Commissioner further finds as a matter of law that denying Respondent compensation for losses that did not occur does not constitute a taking.

Expense Disallowances

148. Respondent argues that the Commissioner has violated due process by retroactively disallowing *bona fide* business expenses.

149. The Commissioner finds as a matter of law that neither the disallowances nor any other aspect of the regulations are retroactive. Proposition 103's rollback are themselves prospective, not "retroactive," even though the time originally set for their distribution has now passed. The insurers' rollback obligation was established prospectively by the initiative at the time of its enactment. The Supreme Court in *Calfarm* subsequently modified the initiative's standard, making the across-the-board 20 percent rollback subject to the constitutional confiscation standard. The Court held that insurers could either immediately reduce their rates to the statutory rollback levels, or they could apply for permission to use a higher rate and upon such application charge the rates requested therein. In choosing the latter option, however, the insurers were subject to the proviso that they must "refund with interest any premiums collected in excess of the rates ultimately approved."

150. Under the procedure established by *Calfarm*, the insurers incurred a rollback obligation in 1989, but payment was deferred until some future date. The insurers' rollback liability remains the difference between the rate

charged by the insurer and the minimum nonconfiscatory level. The Commissioner finds as a matter of law that the Regulations interpreting the constitutional standard and setting forth the principles and procedures by which it is to be calculated do not impose a new or additional liability on any of the insurers who filed rollback exemption applications. Rather, the regulations simply calculate the rollback liability that in fact was incurred when Respondent decided to continue to write insurance after passage of Proposition 103 without reducing its rates voluntarily. The resulting consumer refund here is prospective.

151. The Commissioner also finds as a matter of law that even were the regulations retroactive they could lawfully be applied to 20th Century, since it did not have any "vested right" that would be impaired by such retroactive application.

152. The Commissioner further finds as a matter of law that even were the regulations retroactively applied so as to impair a vested right, such application is sufficiently necessary to the public welfare as to justify the impairment and hence is constitutionally permissible. The Commissioner finds that denial of business expenses found excessive or improperly charged to policyholders is necessary to further the significant state interest of ensuring that consumers receive the full rollbacks to which they are entitled under Proposition 103; that given Respondent's knowledge of Proposition 103, its claims that it thought that it could reduce its rollback obligation by spending money are not credible and it could not have reasonably relied on such a theory; and that 20th Century has taken no actions on the basis of reasonable reliance on the prior law.

153. The Commission finds that even if retroactively applied to Respondent the regulations would not violate Respondent's due process rights because they further a legitimate legislative purpose (lowering insurance rates) by a rational means (reducing and eliminating expenses

charged to consumers that the Commissioner finds unnecessary).

154. Respondent argues that since the Commissioner set the 10 percent rate of return figure as the minimum non-confiscatory rate, when this rate is combined with the retroactive disallowance of bona fide business expenses the result is necessarily confiscatory.

155. The Commissioner finds as a matter of law that the disallowed business expenses in combination with the 10 percent rate of return does not result in a taking.

Free Speech And Equal Protection Issues

156. Respondent claims that the regulations violate its free speech and equal protection rights. The Commissioner finds as a matter of law that the regulations do not violate Respondent's free speech rights. The regulations only prohibit insurers from passing on to consumers the costs of its expenditures on political and institutional message speech. Requiring shareholders to pay such expenses is not an unconstitutional penalty on speech. The Public Utilities Commission ("PUC") has long excluded political expenditures from utility rates.

157. The Commissioner also finds as a matter of law that the regulations do not constitute content-based regulation of speech given that they treat equally all political contributions, lobbying and institutional message speech.

158. The Commissioner finds as a matter of law that the regulations do not violate Respondent's equal protection rights by addressing only insurers' expenditures on political speech. Insurers (and direct-writer insurance companies) are not a suspect class, and the regulations need only have a rational basis to survive constitutional scrutiny. The limits of the Commissioner's jurisdiction provide the rational basis for his adoption of regulations that do not apply to the political speech expenditures by other industries. Nor are insurers the only regulated in-

dustry where shareholders rather than customers are required to pay for political speech. As noted above, the PUC excludes such expenses from utility rates.

159. Respondent argues briefly that the trimodal efficiency standards also raises an Equal Protection problem.

160. The Commissioner finds as a matter of law that the trimodal efficiency standards do not violate Respondent's equal protection rights. The rational basis for the trimodal efficiency standard lies in the differences in the cost structure and services provided by captive agency companies, independent agency companies and direct writers.

The Statutory Argument that the Rollback Exceeds 20% in Some Lines

161. Respondent argued for the first time in its Post-hearing Reply Brief that the rollback formula reduces rates for three of its lines by more than 20 percent, contrary to Proposition 103.

162. The Commissioner finds that Respondent's argument rests on the erroneous premise that the interim steps by which the rollback are calculated are the final result. In fact, the rollback in each and every line is 12.203 percent, almost 8 percentage points below the statutory rollback percentage.

The Inclusion of Investment Income in the Calculation of Rate of Return

163. Respondent raised for the first time in its Post-hearing Reply Brief an objection to the inclusion of investment income on surplus in the calculation of its rate of return.

164. This issue was considered and resolved in the regulations, which properly adopted the method of total return ratemaking. The rulemaking process considered the special characteristics of the insurance industry whereby capital may be kept in the form of liquid assets

and simultaneously support the insurance business and earn investment income.

The Commission's Authority to Promulgate the Rollback Regulations.

165. Respondent argues that the Commissioner lacks the authority to adopt rules to implement Proposition 103.

166. The Commissioner finds as a matter of law that he has the authority to adopt rules and regulations to implement Proposition 103.

167. Respondent argues that the Commissioner is precluded from retroactively applying any of the regulations in the context of 20th Century's rollback determinations because he lacks statutory authority to promulgate retroactive rules.

168. As set forth above, the Commissioner finds that none of the regulations are retroactive. To the extent that the regulations are "retroactive" in that they apply to a past period, the Commissioner also finds that Proposition 103 and *Calfarm* authorize the Commissioner's enactment of regulations that apply to rollback exemption applications for the November 1988 to November 1989 year. Insurance Code Section 1861.01, subdivision (a), specifically requires a rollback for the year beginning November 8, 1988. *Calfarm* did not invalidate Section 1861.01(a). If that provision is to be given effect, the Commissioner's regulations must operate with respect to that time period, which has now passed.

169. In upholding the constitutionality of the rollback, *Calfarm* contemplated that the Commissioner's regulations would apply to rollback exemption applications that had been filed (and were thus pending) before the adoption of any regulations. Thus, the Court directed insurers that chose not to comply with the rollback to file exemption applications immediately, with the Commissioner authorized to order the insurer to "refund excess premiums col-

lected with interest" should he determine that some rate less than the insurer was charging is fair and reasonable.

170. The Commissioner finds that consumers who purchased policies from Respondent between November 8, 1988, and November 8, 1989, are entitled to a refund of 12.203 percent of the premium that they paid on such policies, together with simple interest computed at 10 percent per annum from May 8, 1989, up to and including the date of payment.

ORDER

IT IS HEREBY ORDERED THAT Respondent 20th Century Insurance Company and 21st Century Insurance Company shall refund to consumers who purchased policies from Respondent between November 8, 1988 and November 8, 1989, whether for the first time or by renewal, the sum that represents 12.203 percent of the premium that they paid on such policies, together with simple interest computed at 10 percent per annum from May 8, 1989, up to and including the date of payment.

IT IS FURTHER ORDERED THAT Respondent shall adopt and implement no later than January 1, 1993, a record-keeping system to allocate properly the costs that it incurs in operation of its internal organizations engaged in claim defense and investigation typically classified as ALAE under prevailing industry practice, and to allocate properly its bulk billings, which meets the minimum requirements set forth in paragraph number 53, and shall file a report describing its record-keeping system with the Department's Rate Enforcement Bureau no later than September 30, 1992.

DATED: May 4, 1992

/s/ Elizabeth D. Laporte
ELIZABETH D. LAPORTE
Administrative Law Judge

APPENDIX F

[Minutes Entered 11/10/94]

SUPERIOR COURT OF CALIFORNIA
COUNTY OF LOS ANGELES
DEPT. 15

JCCP002419

E. HOWARD,

Plaintiff,

v.

P. ALEXANDER,

Defendant

"PROPOSITION 103 IMPLEMENTATION CASES"

APPLICATION OF 20TH CENTURY INS. CO. FOR TEMPORARY STAY OF ENFORCEMENT

Matter comes on for hearing and is argued.

Plaintiff Hartford Steam's Request to Strike Commissioner's Appendix of Federal Cases filed November 9, 1994 is denied.

I. Jurisdiction of This Court

The federal cases submitted by the Commissioner are not determinative of this Court's jurisdiction.

State Court jurisdiction to stay State Court Judgment is not a matter of federal law, but of state law.

This Court concludes that it has jurisdiction to stay any judgment pursuant to CCP 918(a), subject only to the limitation set forth in CCP 918(b). That is the plain meaning of the statute. CCP 918(b) does not apply here because this is not an action for money, but an action for declaratory and injunctive relief and for review of administrative action and mandamus pursuant to CCP 1094.5.

There is no exception in CCP Section 918 or case law for judgments filed pursuant to directions of a higher Court. In fact, the Bank of America case impliedly recognized the trial court's jurisdiction to stay a judgment of a higher court pending certiorari.

20th Century and the other insurers effectively and appropriately distinguished Phillips, Hampton, and the other California cases cited by the Commissioner.

It seems self evident that where the application for stay of judgment involves a higher Court decision reversing the decision of a lower Court, the lower Court may not make orders inconsistent with or contradictory to the higher Court's decision. That is the holding of the Hampton Court when it said at page 656 that where the appellate court directs the lower court to enter a specific judgment, that Court "has no discretion but to enter the judgment called for."

The Supreme Court here directed this Court to "render judgment in favor of the Insurance Commissioner and Voter Revolt and against 20th Century, Hartford, State Farm, et al." This Court, recognizing its obligations to comply with that direction, promptly upon receipt of Remittitur, ordered Commissioner's counsel to prepare a proposed judgment and gave other parties reasonable opportunity to object to the proposed judgment.

II. Insurers' Objections to Award of Costs

The insurers contend that the proposed judgment improperly awards costs against them because the Supreme Court did not award costs against them and costs pursuant to CCP 1032 should be denied in the discretion of the Court because the Commissioner has already recovered costs through the statutory recoupment provisions of Proposition 103. The first argument is now irrelevant since the Commissioner has clarified that he is seeking only costs incurred in the trial court.

This Court concludes that pursuant to CCP 1032 it does have discretion to grant or deny costs in this case.

In the exercising of discretion, it is of significance that Proposition 103 statutory provisions provide for recoupment of all costs incurred in connection with implementation of the Proposition 103. It appears that the fees collected have taken into consideration litigation costs, such as have been incurred in this case. There is no evidence of shortfall in the costs recouped to date through the fees.

In the circumstances, granting costs would result in double recovery of costs. Each side shall bear their own costs.

The proposed judgment submitted by Mr. Woocher is signed and ordered filed with the cost provision modified as indicated on the record.

III. 20th Century's Application for Stay of Judgment Pending Petition for Certiorari to the U.S. Supreme Court.

U.S. Supreme Court Rules, Rule 23.3, provides that applications for stay, except in extraordinary circumstances, must first be addressed to the "Court or Courts below. . ."

20th Century contends that it would be irreparably harmed if it was compelled to pay out $120 million before its Certiorari Petition was determined because it could never collect the monies back from the thousands of policy holders, should Certiorari be granted and should it prevail.

20th Century stresses its precarious financial condition and the public interest in the determination of the significant constitutional issues presented.

Lastly, 20th Century argues that a brief stay would not have a significant effect on policy holders, who stand to receive on the average $136 plus interest.

This Court has considered the arguments of the parties and concludes that a temporary stay of the judgment pending the Supreme Court ruling on 20th Century's Petition for Certiori is warranted because

1. the constitutional issues presented are of great public interest and there is reasonable likelihood that certiori will be granted (See Professor Jesse Choper's analysis) and

2. 20th Century will suffer irreparable harm if the judgment is not stayed while the insureds' harm, if any, from a temporary stay is minimal given the small amount of individual refunds, the fact that they bear 10% interest (much more than ordinary investments) and considering the length of time the administrative proceedings and litigation have already taken.

A Stay Order granting temporary stay is signed and ordered filed as reflected in the transcript of the electronic recording monitor.

Notice of Entry of Judgment is filed and served this date on counsel for the Insurance Commissioner, Voter Revolt, Hartford Steam, 20th Century Insurance Company, and State Farm.

Mr. Keller shall serve Notice of Entry of Judgment and judgment on all other parties.

A copy of this minute order and judgment are served by U.S. Mail this date on:

Kent Keller/Steven Weinstein
Barger and Wolen
515 South Flower Street
Thirty-Fourth Floor
Los Angeles, CA 90071-2205

Michael Strumwasser/Fredric Woocher
Strumwasser and Woocher
100 Wilshire Blvd., Suite 1900
Santa Monica, CA 90401

Edward Howard
Hall and Associates
10951 West Pico Blvd.
Los Angeles, CA 90064

Paul Alexander
Heller, Ehrman, White and McAuliffe
525 University Avenue
Palo Alto, CA 94301

Gary Fontana
Thelen, Marrin, Johnson and Bridges
Two Embarcadero Center
San Francisco, CA 94111-3995

APPENDIX G

PERTINENT STATUTORY, CONSTITUTIONAL, AND REGULATORY PROVISIONS

The Fifth Amendment to the United States Constitution provides in pertinent part:

> [N]or shall private property be taken for public use, without just compensation.

The Fourteenth Amendment to the United States Constitution provides in pertinent part:

> [N]or shall any State deprive any person of life, liberty, or property, without due process of law * * *.

Section 1861.01 of the California Insurance Code provides:

§ 1861.01. Insurance rate rollback

(a) For any coverage for a policy for automobile and any other form of insurance subject to this chapter issued or renewed on or after November 8, 1988, every insurer shall reduce its charges to levels which are at least 20% less than the charges for the same coverage which were in effect on November 8, 1987.

(b) Between November 8, 1988, and November 8, 1989, rates and premiums reduced pursuant to subdivision (a) may be only increased if the commissioner finds, after a hearing, that an insurer is substantially threatened with insolvency.

(c) Commencing November 8, 1989, insurance rates subject to this chapter must be approved by the commissioner prior to their use.

(d) For those who apply for an automobile insurance policy for the first time on or after November 8, 1988, the rate shall be 20% less than the rate which was in effect on November 8, 1987, for similarly situated risks.

(e) Any separate affiliate of an insurer, established on or after November 8, 1987, shall be subject to the provisions of this section and shall reduce its charges to levels which are at least 20% less than the insurer's charges in effect on that date.

Section 1861.05 of the California Insurance Code provides:

§ 1861.05. Approval of insurance rates

(a) No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter. In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company's investment income.

(b) Every insurer which desires to change any rate shall file a complete rate application with the commissioner. A complete rate application shall include all data referred to in Sections 1857.7, 1857.9, 1857.15, and 1864 and such other information as the commissioner may require. The applicant shall have the burden of proving that the requested rate change is justified and meets the requirements of this article.

(c) The commissioner shall notify the public of any application by an insurer for a rate change. The application shall be deemed approved sixty days after public notice unless (1) a consumer or his or her representative requests a hearing within forty-five days of public notice and the commissioner grants the hearing, or determines not to grant the hearing and issues written findings in support of that decision, or (2) the commissioner on his or her own motion determines to hold a hearing, or (3) the proposed rate adjustment exceeds 7% of the then applicable rate for personal lines or 15% for commercial lines, in which case the commissioner must hold a hearing upon a timely request.

Title 10 of the California Code of Regulations provides in pertinent part:

Article 3. General Provisions

§ 2643.1. Common Methodology for Review.

While companies remain free to formulate their rates under any methodology, the Commissioner's review of those rates must use a single, consistent methodology.

§ 2643.2. Rating Basis.

Except as otherwise provided in this subchapter, rates are to be computed on the basis of premium charged per exposure. The Commissioner shall, from time to time, specify the appropriate exposure base or bases by line in accordance with section 2646.3.

In lines where the Commissioner finds that rating on some other basis is more appropriate, the Commissioner shall authorize its use.

§ 2643.3. Total Aggregate Earned Premiums.

(a) The determination whether rates are excessive or inadequate is made on the basis of the aggregate earned premiums the rates are expected to produce. Thus, the proposed and approved rates are required to reflect the actual distribution of premiums, including discounts, dividends, credits, and other rating factors affecting aggregate premiums. Rates that are neither excessive nor inadequate may still be unlawful and disapproved if they are unfairly discriminatory or otherwise violate chapter 9 (commencing with section 1851) of part 2 of division 1 of the Insurance Code.

(b) Rate applications (Form CAR-1 (last revised 9/90)) shall be filed on a line-by-line basis, as set forth in section 2642.7.

The application shall be accompanied by the rating manual, rating plan, all policy forms to which changes would have a rate impact, or such other documents as may be necessary to show the distribution of premium within the line. The Comissioner shall require the filing of such other information as he or she deems necessary to review the application.

(c) The earned premium of retrospectively rated and loss-sensitive insurance shall be the manual premium.

§ 2643.4. Line-by-Line Ratemaking.

§ 2643.5. Accounting Principles.

Statutory accounting principles ("SAP"), rather than generally accepted accounting principles ("GAAP"), shall be used to measure equity.

§ 2643.6. Interjurisdictional Allocations.

(a) Data shall be submitted with rate application. Where reliable data exist for California losses, allocated loss adjustment expenses, ancillary income, commissions, state premium taxes, loss reserves, and unearned premium reserves, those data shall be used. Where data are maintained on a multi-state basis only, or where California data are not reliable, the multi-state data shall be allocated to California as follows:

(1) Allocated and unallocated loss adjustment expenses: By dollars of incurred losses.

(2) Commissions and brokerage: By earned premium.

(3) Taxes, licenses, and fees: By actual statutory tax rate for premium tax; by premium for licenses and fees.

(4) Other Acquisition: By number of written exposures or policies.

(5) General: By number of earned exposures or policies.

For purposes of this subsection, the determination whether data are "reliable" shall be made on the basis of whether the Commissioner finds, under the circumstances, that the data are authentic and believable. In making that finding, the Commissioner shall consider, among other things, whether the data were recorded by persons and under circumstances likely to produce accurate data, whether the data were relied upon by the party in its business, and whether the data are consistent with other data.

(b) Where an insurer submits recorded California data that varies from the California allocation of multi-state data allocated as specified in this section, the Commissioner shall require the insurer to demonstrate the accuracy of the data and to justify any deviation from the insurer's experience in other states. Where the Commissioner finds the demonstration or justification inadequate, he or she shall require the use of allocations rather than the submitted recorded data for California. Where the data are expressed as a percentage of earned premium, and are therefore mathematically related to the other components of premium, and the use of data other than the California allocation of multi-state data is authorized, appropriate adjustments shall be made to any related data and to any applicable regulatory standards.

(c) Where an insurer elects to disaggregate a line of insurance into commodity and specialty categories pursuant to section 2642.7, allocations between commodity and specialty shall be in the same proportion as specified in subdivision (a) of this section.

§ 2643.7. Data Availability.

Where an insurer can demonstrate that data required by these regulations are not available, the Commissioner shall authorize the use of substitute data. An insurer seeking authority under this section shall include with its request

(a) the reasons why the data are unavailable to it, with appropriate reference to the practices of other, comparably situated insurers;

(b) justification for use of the substitute data proposed, together with a discussion of other feasible alternatives;

(c) a plan for providing the data required by these regulations, taking into account the practical requirements of full compliance and the size and scope of the insurer's affected operations.

Article 4. Determination of Reasonable Rates

§ 2644.1. Excessive or Inadequate Rates.

No rate shall be approved or remain in effect that is above the maximum permitted earned premium, as defined in section 2644.2, or is below the minimum permitted earned premium, as defined in section 2644.3. Where the Commissioner finds that a rate or proposed rate is excessive or inadequate, the rate or proposed rate shall not be used nor remain in effect. If the rate or proposed rate is excessive, the Commissioner shall indicate the highest rate that would not be excessive, which the insurer may adopt by amendment to its application, or the Commissioner shall reject the rate in its entirety. If the rate or proposed rate is inadequate, the Commissioner shall indicate the lowest rate that would not be inadequate, which the insurer may adopt by amendment to its application, or the Commissioner shall reject the rate in its entirety.

§ 2644.2. Maximum Permitted Earned Premium.

The maximum permitted earned premium is calculated as follows:

(a)(1) projected losses, as defined in section 2644.4,

(2) plus projected allocated loss adjustment expenses, as defined in section 2644.8,

(3) plus projected fixed expenses, as defined in section 2644.9,

(4) minus projected ancillary income, as defined in section 2644.13,

(b) divided by

(1) 1.0,

(2) minus the variable expense factor, as defined in section 2644.14,

(3) minus the maximum profit factor, as defined in section 2644.15,

(4) plus the investment income factor, as defined in section 2644.19.

Stated as a formula:

$$Max\ Permitted\ EP = \frac{losses + ALAE + fixed\ expenses - ancil\ income}{1 - var\ \text{exp}\ factor - profit\ factor + invest\ inc\ factor}$$

§ 2644.3. Minimum Permitted Earned Premium

The minimum permitted earned premium is calculated as follows:

(a)(1) projected losses, as defined in section 2644.4,

(2) plus projected allocated loss adjustment expenses, as defined in section 2644.8, and

(3) plus projected fixed expenses, as defined in section 2644.9,

(4) minus projected ancillary income, as defined in section 2644.13,

(b) divided by

(1) 1.0,

(2) minus the variable expense factor, as defined in section 2644.14,

(3) minus the minimum profit factor, as defined in section 2644.15,

(4) plus the investment income factor, as defined in section 2644.19.

Stated as a formula:

$$Min\ Permitted\ EP = \frac{losses + ALAE + fixed\ expenses - ancil\ income}{1 - var\ \exp\ factor - profit\ factor + invest\ inc\ factor}$$

§ 2644.4. Projected Losses.

(a) "Projected losses" means the insurer's historic losses per exposure, adjusted by catastrophe adjustment, as prescribed in section 2644.5, by loss development, as prescribed in section 2644.6, and by loss trend, as prescribed in section 2644.7.

(b) Projected losses shall be calculated by applying the loss trend factor separately to data from each accident-year in the recorded period. However, for medical malpractice insurance, where the use of claims-made policies predominates throughout the line, projected losses are more appropriately evaluated on a report-year basis; accordingly, for medical malpractice insurance projected losses shall be calculated on a report-year basis, except where occurrence policies predominate.

(c) Where an insurer elects to disaggregate a line of insurance into commodity and specialty categories pursuant to section 2642.7, the insurer shall, in lieu of the computation of projected losses specified in sections 2644.5 through 2644.7, tender an alternative computation of projected losses for the specialty category, which the Commisisoner shall approve if he or she finds the projection to have been made in a sound actuarial manner. Nothing in this section precludes the Commissioner from requiring the additional filing of projected losses computed in the manner specified in section 2644.5 through 2644.7.

§ 2644.5. Catastrophe Adjustment.

In those insurance lines and coverages where catastrophes occur, the catastrophic losses of any one accident year in the recorded period are replaced by a loading based on a multi-year, long-term average of catastrophe claims. The Commissioner shall, from time to time, prescribe the number of years over which the average shall be calculated in accordance with section 2646.3.

§ 2644.6. Loss Development.

"Loss development" is the process by which reported losses are adjusted for anticipated payout patterns. Loss development shall be presented as a loss-development triangle, based on the average of the ratios of losses for the three most recent accident-years available for a reporting interval, for as many reporting intervals as the Commissioner may prescribe for a given line in accordance with section 2646.3. Filings shall contain both paid losses and case-specific reserves, stated separately. Loss development may employ either paid losses or the sum of paid losses and case-specific reserves, provided that if the ratio of case-specific reserves to paid losses increases by an amount greater than a figure to be specified by the Commissioner for the respective lines, in accordance with section 2646.3, loss development shall be based solely on paid losses.

§ 2644.7. Loss Trend.

"Loss trend" is the process by which forces not reflected in historical loss data are expected to affect losses in the rating period.

(a) Loss trend factors shall be established in accordance with section 2646.3 for all insurers writing a given line.

(b) The Commissioner shall, from time to time, adopt trend factors for each line in accordance with section 2646.3. Trend factors shall be based on the exponential

curve of best fit, as measured by the coefficient of determination, and as modified by the Commissioner to take into account factors not reflected in the historical data. Trend factors shall be developed using industry-wide paid pure premium data.

(c) Where the trend factor within a given line significantly varies by subline, by policy limits, by region of the state, or by coverage, the Commissioner shall, in accordance with section 2646.3, adopt separate trend factors in accordance with that evidence.

(d) Changes in the law such as that created by *Moradi-Shalal* v. *Fireman's Fund Ins. Companies* (1988) 46 Cal. 3d 287 can be expected to have a substantial effect on payouts, and consequently the Commissioner shall specify, in accordance with section 2646.3, the manner in which loss data predating *Moradi-Shalal* shall be adjusted in affected lines to take this change in the law into account.

§ 2644.8. Projected Allocated Loss Adjustment Expenses.

(a) "Projected allocated loss adjustment expenses" means the company's historic costs per exposure associated with the adjustment of specific claims, developed and trended in the manner described in sections 2644.6 and 2644.7.

(b) Where an insurer elects to disaggregate a line of insurance into commodity and specialty categories pursuant to section 2642.7, the insurer may, in addition to the computation of projected allocated loss adjustment expenses specified in this section, tender an alternative computation of projected allocated loss adjustment expenses for the specialty category, which the Commissioner shall approve if he or she finds the projection to have been made in a sound actuarial manner.

§ 2644.9. Projected Fixed Expenses.

"Projected fixed expenses" means allowable historic fixed expenses per exposure, adjusted for expense trend, as prescribed in section 2644.11, subject to the efficiency standard specified in section 2644.12. "Fixed expenses" consist of the following:

(a) other acquisition, field supervision, and collection expenses incurred

(b) plus general expenses incurred

(c) plus state and local taxes, licenses, and fees incurred

(d) minus premium taxes

(e) plus unallocated loss adjustment expenses.

Commission and brokerage expenses shall not be included in fixed expenses.

§ 2644.10. Excluded Expenses.

The following expense items shall not be allowed for ratemaking purposes:

(a) Political contributions and lobbying.

(b) Executive compensation that exceeds the reasonable amount for such compensation, as the Commissioner shall from time to time determine in accordance with section 2646.3.

(c) Bad faith judgments and associated allocated loss adjustment expenses.

(d) All costs attendant to the unsuccessful defense of discrimination claims.

(e) Fines and penalties.

(f) Institutional advertising expenses. "Institutional advertising" means advertising not aimed at obtaining

business for a specific insurer and not providing consumers with information pertinent to the decision whether to buy the insurer's product.

(g) All payments to affiliates, to the extent that such payments exceed the fair market rate or value of the goods or services in the open market.

Except as allocated pursuant to section 2643.6, calculation of the amounts expended on the foregoing expense items shall be based on the insurer's national expenditures, allocated among states in proportion to earned premium.

§ 2644.11. Expense Trend.

Allowable historic fixed expenses shall be adjusted for inflation. The Commissioner shall, from time to time, determine in accordance with section 2646.3 the expense trend factor by which allowable historic fixed expenses shall be multiplied. The expense trend factor may vary by insurance line. Unless the Commissioner finds some other method to be more appropriate, the expense trend factor shall be determined by taking the average year-to-year per-exposure fixed expense cost changes for the preceding three years.

§ 2644.12. Efficiency Standard.

(a) Notwithstanding any other provision of these regulations, projected fixed expenses shall not exceed

(1) the product of

(A) projected losses, as defined in section 2644.4,

(B) plus projected allocated loss adjustment expenses, as defined in section 2644.8,

(C) minus projected ancillary income, as defined in section 2644.13,

(2) multiplied by

(A) the efficiency standard, as specified in subdivision (b) of this section,

(B) minus the variable expense factor, as defined in section 2644.14,

(3) divided by

(A) 1.0,

(B) minus the maximum profit factor, as defined in section 2644.15,

(C) plus the investment income factor, as defined in section 2644.19,

(D) minus the efficiency standard, as specified in subdivision (b) of this section.

Stated as a formula:

$$Max\ fixed\ \text{exp} = \frac{(losses + ALAE - ancil\ income)\ (effic\ std - var\ \text{exp}\ factor)}{1 - profit\ factor + invest\ inc\ factor - effic\ std}$$

(b) The Commissioner shall, from time to time, adopt the efficiency standard pursuant to section 2646.3, which shall be expressed as a maximum allowable ratio of historic underwriting expenses to historic earned premiums, which represents the fixed and variable cost for a reasonably efficient insurer to provide insurance and to render good service to its customers.

(c) The efficiency standard shall be set separately for each insurance line, and separately for insurers distributing through independent agents and brokers, through exclusive agents, and through employees of the insurer not functioning as agents. In setting the efficiency standard, the Commissioner shall determine whether, in the long-term, efficiency will be enhanced and premiums lowered by adopting a separate standard for insurers writing large and small amounts of insurance in the line. If the Commissioner determines that such separate standards would have such long-term effects, he or she shall set the stand-

ard separately according to the amount of insurance being written in the line. In lines where the number of insurers employing a given distribution system is, in the judgment of the Commissioner, inadequate for the calculation of a mean that provides a useful efficiency standard, the Commissioner shall adopt a single efficiency standard for that line, which shall apply to all insurers writing in that line regardless of distribution system.

(d) In each category, the efficiency standard shall be set at the weighted mean (weighted by earned premium) expense ratio of insurers in that category. In calculating the average, the Commissioner may exclude insurers for which reliable data are not readily available or which reflect anomalous conditions.

§ 2644.13. Projected Ancillary Income.

"Projected ancillary income" means projected net income to the insurer, or an affiliate of the insurer, not derived from operations directly related to insurance subject to this subchapter. Projected ancillary income shall be expressed on a per-exposure basis. Premium financing revenues and membership dues shall be included within projected ancillary income. "Affiliate" means a company having common management, ownership, or control with the insurer.

§ 2644.14. Variable Expense Factor.

The "variable expense factor" means the sum of the commission rate and the state premium tax rate.

§ 2644.15. Profit Factors.

(a) The "maximum profit factor" means

(1) The maximum permitted after-tax rate of return, as defined in section 2644.16,

(2) divided by the product of

(A) the leverage factor, as defined in section 2644.17,

(B) multiplied by the federal income tax factor, as defined in section 2644.18.

(b) The "minimum profit factor" means

(1) the minimum permitted after-tax rate of return, as defined in section 2644.16,

(2) divided by the product of

(A) the leverage factor, as defined in section 2644.17,

(B) multiplied by the federal income tax factor, as defined in section 264.18.

§ 2644.16. Rate of Return.

The Commissioner shall, from time to time, determine, in accordance with section 2646.3, the maximum and minimum permitted after-tax rate of return for property and casualty insurance ratemaking. The maximum and minimum profit factors shall represent the range of yields on investments in other enterprises presenting risks to investors comparable to property and casualty insurance, giving due consideration to the competing interests of investors and consumers, and taking into account the fact that insurance is imbued with the public interest and that its purchase is sometimes legally required.

§ 2644.17. Leverage Factor and Surplus.

(a) "Leverage factor" means the ratio of net written premiums to surplus.

(b) The Commissioner shall, from time to time, establish, in accordance with section 2646.3, industry-wide leverage factors for each insurance line. Each insurer's surplus shall be allocated to its respective lines in proportion to the industry-wide reserves. In determining the leverage ratios, the Commissioner shall give due consideration to regulatory standards of solvency and actual

industry-wide, all-lines ratio of net written premiums to surplus.

(c) The Commissioner finds that investors' perceived investment risk may vary from line to line. In lines perceived to have higher-risk, the Commissioner may establish, in accordance with section 2646.3, higher surplus requirements, and insurers may earn the rate of return on the higher surplus. Thus, while the rate of return does not vary by line, insurance perceived to have a greater risk will yield higher returns per premium dollar.

§ 2644.18. Federal Income Tax Factor.

(a) "Federal income tax factor" means 1.0 minus the insurer's effective federal income tax rate reported in the most recent year for which historical data are available, giving full account to all tax credits and offsets used or available to the insurer. Where there has been a change in tax laws between the recorded period and the rating period, the effective tax rate shall be calculated using the historical data and the tax rules for the rating period.

(b) Where the insurer had a net tax credit, or where the insurer had a net tax liability on a net pretax loss, the effective tax rate shall be zero and

(1) if the insurer had a net tax credit, the amount of the credit shall be added, as a positive number, to nationwide projected ancillary income;

(2) if the insurer had a net tax liability, the amount of the liability shall be subtracted from nationwide projected ancillary income.

(c) Where the insurer's effective tax rate reported in the most recent year for which historical data are available exceeded 34% and the insurer had a net tax liability on a net pretax profit, the effective tax rate shall be 34% and the amount by which the tax liability exceeded 34% shall be subtracted from nationwide ancillary income.

§ 2644.19. Investment Income Factor.

"Investment income factor" means the projected yield, as defined in section 2644.20, multiplied by the sum of

(a) the reserves ratio, as defined in section 2644.21,

(b) plus the surplus ratio, as defined in section 2644.22.

§ 2644.20. Projected Yield.

"Projected yield" means the insurer's imbedded yield in the most recent year for which investment results have been reported, plus an average of the insurer's realized captial gains over the most recent five years. Imbedded yield shall be calculated as the insurer's net investment income, excluding capital gains, divided by the average of the insurer's start-of-year and year-end surplus and reserves for the most recent year for which investment results have been reported.

§ 2644.21. Reserves Ratio.

"Reserves ratio" means

(a) the average of the last two years'

(1) loss reserves, plus

(2) loss adjustment expenses reserves, plus

(3) unearned premium reserves

(b) divided by the earned premium for the most recent year for which data are available.

§ 2644.22. Surplus Ratio.

"Surplus ratio" means the reciprocal of the leverage factor.

Stated as a formula:

$$\textit{surplus ratio} = \frac{1}{\textit{leverage factor}}$$

§ 2644.23. Credibility Adjustment.

(a) To the extent that the maximum and minimum permitted earned premiums are based upon data that lack credibility, a credibility adjustment shall be made, as appropriate, to projected losses, projected allocated loss adjustment expenses, projected loss development, and projected allocated loss adjustment expenses development.

(b) The Commissioner shall, from time to time, specify credibility criteria and appropriate sources of substitute data in accordance with section 2646.3.

(c) The credibility adjustment shall consist of adding to the insurer's data sufficient additional data, drawn from an approved source of substitute data, approved in accordance with section 2646.3, to provide a total sample size sufficient to meet the applicable credibility criterion established by the Commissioner.

Article 5. Determination of Rates for Rollback Period

§ 2645.1. Scope.

This article applies to all rates charged for insurance issued or renewed on or after November 8, 1988, and not after November 7, 1989.

§ 2645.2. Findings.

The Commissioner finds:

(a) Proposition 103 requires that all rates charged during the rollback period be reduced by 20% from their November 8, 1987, levels. Consumers are entitled to receive, and insurers are obligated to give, this reduction, except to the extent that it violates the insurers' constitutional rights.

(b) Insurers are entitled to rates during the rollback period that are not confiscatory. Rates are confiscatory if and only if all the rates charged by an entire group of

insurance companies sharing a single ownership or control are, taken as a whole, confiscatory.

(c) To the extent that the rates specified by Proposition 103 for the rollback period are confiscatory, insurers are entitled to a rate above the level prescribed by the initiative, but no higher than necessary for the rates not to be confiscatory.

(d) Historical data shall be used in lieu of forecasts for the rollback period because actual historical data exist for many of the figures that are forecast in prior-approval ratemaking, making it possible to avoid the errors inherent in forecasting and resulting in greater accuracy.

§ 2645.3 General.

(a) Except as otherwise specified in this article, rates for the rollback period shall be evaluated in the manner specified in article 4 of this subchapter. To the extent that rates charged during the rollback period exceeded the minimum permitted earned premium, the excess shall be refunded to consumers with interest as set forth in section 2544.9.

(b) Rollback calculations shall be made on an aggregate basis, rather than on a per-exposure basis. Interjurisdictional allocations shall be made as specified in section 2643.6, except that calculations specified in subdivisions (a)(4) and (a)(5) of section 2643.6 shall be made on the basis of earned premium. Leverage factors shall be computed in accordance with section 2644.17.

(c) While premiums paid for surety, credit, and financial guaranty insurance have been exempted by the Legislature from the requirement that they be rolled back, the amount of the rollback due on other property-casualty insurance, to the extent that the rollback is constrained by constitutional limits, is properly determined by evaluating the profitability of all the insurer's California property-casualty insurance not excluded by section 1851 of the

Insurance Code. Accordingly, the minimum earned premium shall be calculated on all property-casualty insurance not excluded by section 1851 of the Insurance Code, including surety, credit, and financial guaranty.

(d) The option to disaggregate data within lines as provided by section 2642.7 shall not apply to rollback year calculations.

(e) Minimum permitted earned premium shall be determined on an all-lines combined, groupwide basis.

§ 2645.4. Losses and Allocated Loss Adjustment Expenses.

In lieu of projected losses and loss adjustment expenses, actual loss and loss adjustment expense data for calendar year 1989 shall be used.

(a) Catastrophe adjustment. No adjustment of losses for catastrophes shall be made.

(b) Loss development and trending. Actual incurred losses shall be used, subject to validation by the Commissioner to ensure that there has not been inappropriate reserves-strengthening. Because incurred losses for calendar year 1989 are now known, no loss development is necessary or appropriate and loss and loss adjustment expense trend would have so insubstantial an effect on rates that no adjustment shall be made.

(c) Reserves-strengthening. The Commissioner will not adjust an insurer's 1989 reserves when any of the following conditions are found:

(1) Reserves: Premium, One-Year Test. When the year-end 1989 loss reserves to 1989 earned premiums is less than or equal to the year-end 1989 loss reserves to 1988 earned premiums.

(2) Reserves: Premium Four-Year Test. When the 1989 reserves-to-premium ratio is less than or equal to the average of the reserves-to-premium ratios for 1985 through 1988.

(3) Incurred Versus Paid Test. When the ratio of 1989 incurred losses to 1988 incurred losses was no greater than the ratio of the payments on 1989-incurred losses was to payments on 1988-incurred losses.

(d) If the insurer satisfies none of the three tests in subdivision (c) of this section, unless the Commissioner finds, based on evidence proffered by the insurer and any other party, that some other number better reflects appropriate reserve levels, the insurer's reserves shall be adjusted, on a line-by-line, company-specific basis, to the same multiple of earned premium as the 1985 through 1988 reserves had to 1985 through 1988 earned premium. The adjustment, stated as a formula, is as follows:

$$\begin{matrix}\text{1989} \\ \textit{reserves}\end{matrix} = \begin{matrix}\text{1989 } \textit{earned} \\ \textit{premium}\end{matrix} \left[\frac{\text{1985-1988 } \textit{reserves}}{\text{1985-1988 } \textit{earned premium}} \right]$$

§ 2645.5. Fixed Expenses.

(a) Executive compensation in excess of the insurer's maximum permissible executive compensation shall be deducted from fixed expenses. For purposes of this computation, the following shall apply:

(1) "Executive" means the insurer's five highest-paid policymaking positions in each insurance group.

(2) "Compensation" means the total cash paid, including salary and bonus.

(3) "Maximum permissible executive compensation" means:

(A) For the highest paid executive in the group:
$\max comp = 1077(10^{1.4600 + 0.4060 \log X})$

(B) For the second-highest paid executive in the group:
$\max comp = 1077(10^{1.4140 + 0.3490 \log X})$

(C) For the third-highest paid executive in the group:
$\max comp = 1077(10^{1.2810 + 0.3820 \log X})$

(D) For the fourth-highest paid executive in the group:
$\max comp = 1077(10^{1.2470 + 0.3580 \log X})$

(E) For the fifth-highest paid executive in the group:
$\max comp = 1077(10^{1.2460 + 0.3420 \log X})$

where X is the greater of (i) the insurer's total 1989 countrywide direct earned premium for lines of business subject to Proposition 103 divided by 1,000,000 or (ii) 70.

(b) For rollback calculations, fixed expenses for each line shall be set at the lower of the quantity specified in section 2644.12, subdivision (a), or actual recorded expenses for calendar year 1989. For rollback calculations the term "maximum profit factor" in section 2644.12 means "profit factor" as defined in section 2645.6.

(c) For rollback calculations, the following table shall be used to determine the efficiency standard:

Line	*Captive Writer*	*Direct Writer*	*Independ Agency*
Fire	41.50%	28.83%	41.88%
Allied Lines	36.65%	29.54%	33.20%
Farmowners Multiple Peril	36.16%	36.16%	36.16%
Homeowners Multiple Peril	32.77%	24.28%	40.86%
Commercial Multiple Peril	34.02%	30.13%	39.59%
Inland Marine	32.91%	33.99%	33.10%
Financial Guaranty	15.01%	15.01%	15.01%
Medical Malpractice	18.36%	18.36%	18.36%
Earthquake	41.13%	17.35%	30.94%
Other Liability	35.01%	14.92%	28.63%
Pvt Pass Auto Liability	27.01%	19.01%	33.16%
Comml Auto Liab	33.86%	19.78%	31.63%
Pvt Pass Auto Phys Damage	27.13%	19.87%	34.49%
Comml Auto Phys Damage	31.81%	17.04%	35.97%
Aircraft	24.07%	29.22%	24.27%
Fidelity	26.84%	26.84%	26.84%
Surety	42.56%	51.77%	53.76%
Glass	39.97%	39.97%	39.97%
Burglary & Theft	27.48%	27.48%	27.48%
Boiler & Machinery	27.86%	31.76%	52.54%
Credit	44.69%	44.69%	44.69%

§ 2645.6. Profit Factor.

(a) The after-tax rate of return for property and casualty insurance, corresponding to the lower boundary of the range of reasonable returns, is 10.0 percent.

(b) For the rollback period, leverage factor for each line shall be determined on a groupwide basis for the following table:

Line	*Leverage Ratio*
Fire	3.50:1
Allied Lines	3.50:1
Farmowner Multiple Peril	2.50:1
Homeowner Multiple Peril	2.50:1
Commercial Multiple Peril	1.75:1
Inland Marine	3.50:1
Medical Malpractice	1.00:1
Earthquake	2.00:1
Other Liability	1.00:1
Private Passenger Auto Liability	2.00:1
Commercial Auto Liability	2.00:1
Private Passenger Auto Physical Damage	5.50:1
Commercial Auto Physical Damage	5.50:1
Aircraft	1.00:1
Fidelity	2.00:1
Glass	5.50:1
Burglary & Theft	4.00:1
Boiler & Machinery	2.50:1

(c) To the extent that an insurer has operated during calendar-year 1989 on less surplus than the leverage factor would prescribe, the insurer's actual leverage ratio shall be used. The insurer's actual leverage ratio shall be computed by allocating the insurer's surplus to lines in proportion to the insurer's average 1989 reserves as specified in section 2644.21.

§ 2645.7. Credibility.

No adjustment shall be made for credibility in rollback calculations.

§ 2645.8. Investment Income.

The insurer's imbedded yield, plus the five-year average (1985 through 1989) of realized capital gains, shall be used in lieu of the projected yield. Imbedded yield shall be calculated as the insurer's net investment income, excluding capital gains, divided by the average of the insurer's year-end surplus and Reserves for 1988 and 1989. The Insurer's five-year average realized capital gains shall be calculated as the means of the quotients, for each year 1985 through 1989, of the annual realized capital gains and the average of the insurer's year-end surplus and reserves for that year and the previous year.

§ 2645.9. Amount of Refund.

(a) "Statutory percentage" means the larger of

(1)(A)(i) total 1989 direct premium earned, excluding surety, credit, and financial guaranty insurance,

(ii) minus total 1989 direct premium earned, excluding surety, credit, and financial guaranty insurance, adjusted to be on the rate level of November 8, 1987, multiplied by 0.8,

(B) divided by total 1989 direct premium earned, excluding surety, credit, and financial guaranty insurance, or

(2) zero.

(b) "Constitutional percentage" means the larger of

(1)(A)(i) total 1989 direct premium earned, including surety, credit, and financial guaranty insurance,

(ii) minus the minimum permitted earned premium, including surety, credit and financial guaranty insurance,

(B) divided by total 1989 direct premium earned, excluding surety, credit, and financial guaranty insurance, or

(2) zero.

(c) "Refund percentage" means the lesser of the statutory percentage and the constitutional percentage.

(d) for purposes of determining the insurer's rollback obligation, policyholder dividends paid during calendar year 1989 by the insurer shall be treated as follows:

(1) as a refund of premium to the extent that they do not exceed the average dividend, computed as a percent of earned premium, paid in calendar years 1986 through 1988;

(2) as a voluntary rollback and a credit against the rollback obligation owed to consumers who received the dividend to the extent that the dividends exceed the amount specified in subparagraph (1), above.

(e) Each person from whom premiums were collected for policies issued or renewed during the rollback period for coverages other than surety, credit, or financial guaranty insurance shall receive the amount equal to the premiums paid on such policies multiplied by the refund percentage. To this amount shall be added interest, calculated at 10% per annum, from May 8, 1989, to the date of payment.

(f) Every insurer ordered to make a rollback refund shall, on the first three anniversaries of the date of the order, file a report with the Department of Insurance showing the status of the refund payments.

(g) The Commissioner shall require the insurer to file periodic reports establishing its diligent efforts to deliver the refund to each person entitled to a refund before the refund becomes subject to the Unclaimed Property Law, Code of Civil Procedure section 1500 et seq. The Commissioner shall require that the periodic reports be filed quarterly unless the Commissioner finds that more frequent reports are necessary to ensure compliance.